Supreme Court, U.S.
FILED

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

NATIONSMART CORPORATION, ET AL.,
Petitioners,

v.

HELEN S. PALMQUIST, BRIAN PALMQUIST, JOHN D. PALMQUIST, AND JACK CARLON,
Respondents.

Petition for a Writ of Certiorari to the
United States Court of Appeals for the Eighth Circuit

APPENDIX TO PETITION FOR WRIT OF CERTIORARI

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 96-4132

In re NationsMart Corporation
Securities Litigation

Jack Carlon, Helen S. Palmquist,
Brian Palmquist, John D. Palmquist,
Appellants,

v.

Michael E. Thaman, Alice E.
Brueggemann, S. Leslie Flegel,
Mel A. Friedman, Alan G. Johnson,
Franklin A. Jacobs, S. Lee Kling,
Michael J. Dunlap, RAS Securities
Corp., Pauli & Company, Inc.,
and NationsMart Corporation,
Appellees.

On Appeal from the United States District Court for the
Eastern District of Missouri.

Submitted: September 11, 1997
Filed: November 21, 1997

Before RICHARD S. ARNOLD, Chief Judge, FLOYD R. GIBSON and BEAM, Circuit Judges.

RICHARD S. ARNOLD, Chief Judge.

In this case, Jack Carlon, Helen S. Palmquist, Brian Palmquist, and John D. Palmquist appeal the District Court's dismissal of their class action brought under Sections 11 and 15 of the Securities Act of 1933, 15 U.S.C. §§ 77k(a) and 77(*o*) (1994); Section 12(2) of the Securities Act, 15 U.S.C. § 77*l* (2) (1994); and Sections 10(b) and 20 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t (1994). This litigation involves alleged misrepresentations, misstatements, and omissions made in connection with an initial public offering on December 22, 1993, of shares in NationsMart, a Missouri corporation formed to manage laundry, dry-cleaning, and shoe-repair centers in large retail stores such as Wal-Mart and Kmart. The defendants in the action below, and the appellees before this court, include NationsMart; eight of NationsMart's officers and directors; and NationsMart's two lead underwriters, RAS Securities Corporation and Pauli & Company, Inc.[1] The District Court dismissed the plaintiffs' complaint for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6) and for failure to plead fraud with particularity under Federal Rule 9(b). We now affirm in part and reverse in part.

I.

NationsMart was formed in 1992 with the goal of applying the low-price, one-stop shopping concept, made successful by Wal-Mart and Kmart "supercenters," to the dry-cleaning, laundry, and shoe-repair markets. After filing a Registration Statement and a Prospectus with the Securities and Exchange Commission ("SEC"), NationsMart commenced an initial public

[1]The plaintiffs also filed Securities Act and Securities Exchange Act claims against 25 additional underwriters in a complaint filed on July 12, 1995. The District Court dismissed the claims against these underwriters on statute-of-limitations grounds. The class representatives do not contest the dismissal of these additional underwriters on appeal. See Appellee's Br. at 7.

offering of two million units at $7.00 per unit on December 22, 1993.[2] The Prospectus stated that NationsMart expected to raise $11.7 million in its public offering, and that it intended to use the net proceeds to fund the 51 existing NationsMart stores and to open 108 new stores by November 1994. Under the plan for growth set forth in the Prospectus, the company would open 600 new stores by 1998.

The Prospectus contained detailed financial data about NationsMart, a discussion and analysis of the company's financial situation and the results of its operation, and its strategy for future growth. It acknowledged that NationsMart had previously experienced financial losses, but stated that NationsMart's management believed that, based on a "financial model," projected income from existing stores, as well as the proceeds of the public offering, would "significantly improve the capital resources of the Company and thereby address certain of the going concern conditions." A section of the Prospectus labeled "Risk Factors" included some of the risks investors faced in buying offered units, such as NationsMart's limited operating history and the absence of a prior market for its shares; its dependence on leases from Wal-Mart, Kmart, and other "host retailers"; the competition it faced from other retailers; and its need for additional financing in the future. The Prospectus also cautioned that NationsMart's financial model reflected "only the best judgment of management" and was subject to conditions beyond the company's control.

On July 14, 1994, NationsMart announced that it was experiencing slower-than-expected growth and that it would open 35 to 45 fewer stores than anticipated in the Prospectus. NationsMart also disclosed that it had settled a "whistleblower" lawsuit with

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[2]A "unit" consisted of one share of common stock and a warrant to purchase an additional share of common stock. Consolidated Amended Class Action Complaint ("Complaint") ¶ 1.

Alice Brueggemann, a former senior vice president and chief financial officer who had sued NationsMart after she was discharged in March 1994. Following these announcements, NationsMart's common stock fell to $1.875 and continued to decline until mid-1995, when the stock was delisted.

On November 4, 1994, Helen, Brian, and John Palmquist filed a class action against the defendants in the Northern District of Illinois; and on November 7, 1994, Jack Carlon filed a class action against the defendants in the Eastern District of Missouri.[3] The Palmquists' case was transferred to the Eastern District of Missouri in February 1995, and the four plaintiffs were permitted to file a consolidated class-action complaint on May 1, 1995.[4] It is this complaint that is the subject of this appeal.

In the consolidated complaint, the plaintiffs asserted three bases for relief. Count I alleged violations of Sections 11 and 15 of the Securities Act of 1933 by all of the defendants. Count II alleged violations of Section 12(2) of the Securities Act of 1933 by NationsMart and the two lead underwriters. And Count III alleged violations of Section 10(b) and 20 of the Securities

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[3]In the original complaint filed by Mr. Carlon, James Tellatin was named as a plaintiff and class representative. Mr. Carlon filed an amended complaint on November 14, 1994, which dropped Mr. Tellatin as a named party in this action.

[4]On November 22, 1995, the District Court entered an order certifying two classes of plaintiffs pursuant to Federal Rules of Civil Procedure 23(a) and 23(b)(3). The first class, represented by Jack Carlon and Helen Palmquist, included "all persons who purchased the securities of NationsMart . . . in the Offering . . . and who suffered damages as a result thereof." The second class, represented by Helen Palmquist, included "all persons who purchased NationsMart securities in the Offering . . . or in the open market during the period from December 22, 1993, through August 18, 1994, and who suffered damages as a result thereof." Both classes excluded the defendants and their family members or successors. See Appellants' Appendix at 216-221. The first class appears to be entirely included within the second.

Exchange Act of 1934 and SEC Rule 10b-5 by all defendants. Factually, the complaint alleged that the defendants made false statements in and omitted material information from the Prospectus. It alleged that, given the projections of NationsMart's underwriters, the defendants knew that the company would not be able to implement the business plan outlined in the Prospectus with the proceeds of the offering. Complaint ¶¶ 22-25, 30. The plaintiffs also claimed that the defendants failed to disclose certain facts learned by NationsMart's management in the months before the effective date of the public offering, including the fact that favorable trends described in the Prospectus were not materializing and were not likely to materialize; that the costs to operate existing NationsMart stores and the cost to open new stores had been increasing; and that corporate overhead was increasing. Complaint ¶¶ 40-43. The complaint went on to allege that after the public offering the defendants continued to make statements touting NationsMart's plans to open new stores which they knew had no reasonable basis in fact, including allegedly misleading statements made to investors and statements made in annual and quarterly reports filed with the SEC. Complaint ¶¶ 45-51.

In a memorandum opinion and order on April 11, 1996, the District Court dismissed all claims against NationsMart and its directors and officers, and it dismissed most of the claims against RAS and Pauli & Company, the two lead underwriters. The Court allowed part of the § 12(2) claim in Count II of the complaint to survive with respect to the two lead underwriters. In a second opinion on November 6, 1996, the District Court dismissed the remainder of the § 12(2) claim against RAS and Pauli & Company. In these opinions, the District Court held that the plaintiffs had failed to state a claim under Federal Rule of Civil Procedure 12(b)(6) and had failed to allege fraud with particularity under Federal Rule of Civil Procedure 9(b). In the April 11 opinion and order, the District Court dismissed the case

with prejudice and without leave to amend. Nevertheless, the plaintiffs later sought leave to amend the complaint and vacate the April 11 order. The District Court denied this motion in its November 6 order, stating that the plaintiffs' failure to amend the complaint before the Court entered its April 11 order constituted undue delay.

This case is now before us on appeal of Jack Carlon and Helen, Brian, and John Palmquist.

II.

For the reasons given below, we hold that the District Court erred when it dismissed the plaintiffs' claim against all defendants under § 11 of the Securities Act of 1933.

A.

The District Court based its dismissal of the complaint in part on the plaintiffs' failure to plead specific facts pursuant to Federal Rule of Civil Procedure 9(b) to support the allegations of liability under § 11 of the Securities Act. Under Federal Rule 9(b), in a complaint averring fraud, "the circumstances constituting fraud or mistake shall be stated with particularity." We hold that the particularity requirement of Rule 9(b) does not apply to claims under § 11 of the Securities Act, because proof of fraud or mistake is not a prerequisite to establishing liability under § 11.

Section 11 imposes civil liability on persons preparing and signing materially misleading registration statements. 15 U.S.C. § 77k(a) (1994). A registration statement is materially misleading if it contains an untrue statement of material fact or if it omits a material fact necessary to prevent the statement from being misleading. *Id.* Any person who purchases a registered security is entitled to sue under this section. *Id.* Section 11 imposes "a stringent standard of liability on the parties who play a direct role

in a registered offering." *Herman & MacLean v. Huddleston,* 459 U.S. 375, 381-82 (1983) (footnotes omitted). To establish a prima facie § 11 claim, a plaintiff need show only that he bought the security and that there was a material misstatement or omission. Scienter is not required for establishing liability under this section. *Id.* at 382; *In re Stac Electronics Securities Litigation,* 89 F.3d 1399 (9th Cir. 1996), *cert. denied,* 117 S . Ct. 1105 (1997). The liability of the issuer of a materially misleading registration statement is "virtually absolute, even for innocent misstatements." *Herman & MacLean,* 459 U.S. at 382 (footnote omitted). Persons beside the issuer who face liability under § 11—which includes anyone who signed the registration statement, such as officers, directors, and underwriters—must prove that, after reasonable investigation, they had reasonable grounds to believe that the statement was not materially misleading. 15 U.S.C. § 77k(b)(3); *Herman & MacLean,* 459 U.S. at 382.

In their complaint, the plaintiffs made clear that they did not allege in the context of their § 11 claim that the defendants were liable for fraudulent or intentional conduct. Complaint ¶ 74 Therefore, their claim should not have been dismissed for failing to comply with Rule 9(b). And even if the plaintiffs were alleging fraudulent conduct under § 11, as the defendants argue in their brief, any such allegation would be mere surplusage. The only consequence of a holding that Rule 9(b) is violated with respect to a § 11 claim would be that any allegations of fraud would be stripped from the claim. The allegations of innocent or negligent misrepresentation, which are at the heart of a § ll claim, would survive. The plaintiffs' case should not have been dismissed because they alleged more than was necessary to recover under § 11 of the Securities Act.

We recognize that other courts have sometimes applied Rule 9(b) to claims brought under §§ 11 and 12(2) of the Securities Act of 1933. Such claims are said to be subject to Rule 9(b) when they

are "grounded in fraud." *Melder v. Morris,* 27 F.3d 1097, 1100 n.6 (5th Cir. 1994); *In re Stac Electronics Securities Litigation,* 89 F.3d at 1404-05 (footnote omitted). *Accord, Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 288 (3d Cir.), *cert. denied*, 506 U.S. 934 (1992); *Sears v. Likens,* 912 F.2d 889, 892-93 (7th Cir. 1990). Defendants ask that we follow these authorities and affirm the dismissal of the §§ 11 and 12 (2) counts of this complaint for failure to comply with Rule 9(b). We decline to do so for two reasons. First, the complaint in this case expressly disavows any claim of fraud in connection with the § 11 and § 12(2) counts, as we have already noted. See *Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1223 (lst Cir. 1996) (complaint avoids grounding in fraud; allegation that defendants actually possessed the information they failed to disclose is not an averment of fraud sufficient to subject the complaint to Rule 9(b)). In addition, a pleading standard which requires a party to plead particular facts to support a cause of action that does not include fraud or mistake as an element comports neither with Supreme Court precedent nor with the liberal system of "notice pleading" embodied in the Federal Rules of Civil Procedure. Federal Rule 8(a)(2) requires a plaintiff to plead only "a short and plain statement of the claim showing that the pleader is entitled to relief . . . ." See *Conley v. Gibson,* 355 U.S. 41, 47 (1957) ("[T]he Federal Rules of Civil Procedure do not require a claimant to set out in detail the facts on which he bases his claim."). Rule 9(b) imposes a heightened pleading requirement for allegations of fraud and mistake; but, as we noted above, § 11 does not require proof of fraud for recovery. The Supreme Court has held that federal courts may not apply the heightened pleading standard of Rule 9(b) outside the two specific instances—fraud and mistake—explicitly found in the Rule. See *Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit*, 507 U.S. 163, 168 (1993) (holding that a federal court may not impose a standard more stringent than the pleading

requirements of Rule 8(a) in civil rights cases alleging municipal liability under 42 U.S.C. § 1983).

The plaintiffs' allegations complied with the "short and plain statement" requirement of Federal Rule 8(a). The plaintiffs alleged that they bought NationsMart stock and that "[t]he Offering Materials contained untrue statements of material facts and omitted facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." Complaint ¶ 68. Specific instances of misstatements were also pleaded. Given the broad scope of liability under § 11 and the liberal pleading requirements of Federal Rule 8(a), these allegations are sufficient to state a claim. Therefore, the District Court should not have dismissed the complaint under Rule 12(b)(6).

B.

The District Court also based its dismissal of part of the plaintiffs' § 11 claim on the "safe harbor" provision of SEC Rule 175, which protects "forward-looking statements" made in documents filed with the SEC. Under this regulation, a "forward-looking statement" can include statements containing projections of revenue, income, earnings per share, capital expenditures, dividends, or capital structure; statements of management's future plans and objectives; and statements of future economic performance contained in the management's discussion and analysis of financial conditions. 17 C.F.R. § 230.175(c) (1997). A forward-looking statement is protected from liability under the Securities Act of 1933 and "shall be deemed not to be a fraudulent statement . . . unless it is shown that such a statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith." 17 C.F.R. § 230.175(a) (1997). "Fraudulent" for purposes of Rule 175 does not mean fraud in the traditional sense, but instead simply denotes any of the bases of liability under the Securities Act, including liability under § 11. See *Wielgos v. Commonwealth Edison Co*, 892 F.2d

509, 513 (7th Cir. 1989); 17 C.F.R. § 230.175(d) (1997). Therefore, material misstatements in a registration statement may be protected from §11 liability if they are forward-looking.

Many of the statements in the Prospectus challenged by the plaintiffs were indeed forward-looking. The plaintiffs challenged NationsMart's projections that it would open 108 new stores by 1994 and 600 new stores by 1998; that the proceeds from the public offering would be sufficient to cover the plans for expansion; and that NationsMart's history of operating losses would give way to future growth. Complaint ¶ 22-26, 29. The plaintiffs did not argue in their complaint or before the District Court that these statements were not forward-looking; rather, they alleged that the defendants' statements "were false and had no reasonable basis because [the defendants] knew that there were no valid assumptions underlying the projections." Complaint ¶ 31. Forward-looking statements are not protected by Rule 175 if they are not generally believed, if they lack a reasonable basis, or if the speaker knows of undisclosed facts which seriously undermine the accuracy of the statement. *In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1113 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990). However, the District Court held that the plaintiffs could not avoid the "safe harbor" of SEC Rule 175 by claiming that the defendants had no reasonable basis for their projections because, under Rule 9(b), the plaintiffs did not plead specific facts which showed that the statements either had no reasonable basis or were not believed by the defendants.

We have already held that the specificity requirement of Rule 9(b) does not apply to claims brought under § 11 of the Securities Act. The District Court and the defendants have cited several cases which require plaintiffs to plead specific facts in order to avoid the safe-harbor rule. See *In re Healthcare Compare Corp. Securities Litigation*, 75 F.3d 276 (7th Cir. 1996); *Arazie v. Mullane*, 2 F.3d 1456 (7th Cir. 1993); *Roots Partnership v.*

Lands' End, Inc., 965 F.2d 1411 (7th Cir. 1992). However, the claims in these cases were brought only under § 10(b) of the Securities Exchange Act of 1934, which requires proof of fraud as one of its elements. Application of the specificity requirement of Rule 9(b) would be appropriate if the "safe harbor" protected the defendant from a cause of action involving true fraud. But § 11 claims do not involve fraud, and the plaintiffs did not have to plead specific facts to avoid the safe harbor rule.

In the complaint, the plaintiffs attacked statements of historical fact as well as the defendants' forward-looking statements. The District Court dismissed the plaintiffs' allegations under § 11 of false statements of historical fact on the basis that these allegations did not comport with Federal Rule 9(b). These challenged statements from the Prospectus include the statement that NationsMart dealt with its affiliates at arm's length; the statement that NationsMart was complying with federal wage and hour laws; the dollar figure representing the cost of opening a new store; and statements describing revenue, profit, and expense trends. Complaint ¶¶ 2, 33, 41. The plaintiffs also alleged that the defendants omitted material information from the prospectus in failing to disclose adverse trends the company was experiencing in the months immediately preceding the public offering. Complaint ¶ 42. As we noted above, Rule 9(b) does not apply to claims brought under § 11. The allegations of false statements of historical fact and of material omissions were sufficient to state a claim.

The defendants argue that the plaintiffs have waived on appeal any argument that statements of historical fact in the Prospectus do not comply with Rule 9(b) because "the plaintiffs' brief does not discuss or dispute this aspect of the district court's ruling." Appellees' Br. at 30. We do not agree. The plaintiffs forcefully argued in their brief that Rule 9(b) should not apply to claims brought under § 11 and argued that the defendants omitted

material facts from the Prospectus. Appellants' Br. at 17-20, 25-27. Accordingly, we hold that they did not waive this argument on appeal.

C.

The District Court also dismissed the plaintiffs' § 11 claim because, according to the Court, the Prospectus contained numerous statements which "bespoke caution" and warned investors of the financial risks they were taking when they bought stock in NationsMart. This Court has recognized that specific cautionary statements in offering materials which disclose potential investment risks may defeat a plaintiff's claim that the offering materials were materially misleading under federal securities law. See *Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 949 F.2d 243, 245-46 (8th Cir. 1991); *Polin v. Conductron Corp.*, 552 F.2d 797, 806-07 (8th Cir.), *cert. denied*, 434 U.S. 857 (1977). Cautionary statements, however, cannot be general risk warnings or mere boilerplate; they must be detailed and specific. See *Moorhead*, 949 F.2d at 245-46.

The Prospectus contained a section labeled "Risk Factors" which warned of potential problems NationsMart faced as a growing company. The Risk Factors section emphasized NationsMart's limited operating history, its dependence on third parties such as Wal-Mart and Kmart, its inability to continue operations without the proceeds of the offering, and its need for financing other than the proceeds of the offering to operate beyond October 1994. Appendix at 584-588. NationsMart's operating losses up to September 26, 1993, were also reported in the Risk Factors section. *Id.* at 584. In another part of the Prospectus, in which the defendants described NationsMart's business plan for future growth, they stated that "the financial model used by the Company reflects only the best judgment of management and actual results are substantially dependent on numerous factors . . . ." *Id.* at 597.

Many of the warnings of short-term risks to investors, however, were generic and nonspecific. The complaint alleges that the defendants did not adequately warn investors of the potential risks faced by NationsMart between the time of the offering and October 1994, when the Prospectus admitted that the company would have to find new sources of revenue. Many statements in the Risk Factors section—such as the warning that "[t]here can be no assurance that any of the Company's Centers or that the Company as a whole will generate income from operations or provide cash from operating activities in the future"—do not provide the sort of detail that would "bespeak caution" to a potential investor. Though the Prospectus did state that "the Company expects to continue to incur net losses and negative cash flow from operations during 1994 and 1995," Appendix at 584, this warning must be read in conjunction with statements elsewhere in the Prospectus that

> [b]ased upon its financial model, management believes that previously experienced operating losses will diminish as currently operating Centers, most of which have been open fewer than six months, begin to generate income from operating activities. Additionally, the net proceeds of this offering will significantly improve the capital resources of the Company and thereby address certain of the going concern conditions.

Appendix at 597. There is no warning anywhere in the Prospectus detailing the specific risk that NationsMart would continue to face severely declining profits and ballooning corporate overhead in the short term, between the date of the offering, December 1993, and October 1994, which threatened the company's ability to operate.

In addition, the bespeaks-caution doctrine cannot immunize the defendants from liability under § 11 if they omitted material

information from the offering materials. See *Griffin v. McNiff*, 744 F. Supp. 1237, 1254 (S.D.N.Y. 1990), *aff'd without opinion*, 996 F.2d 303 (2d Cir. 1993); *Robbins v. Moore Medical Corp.*, 788 F. Supp. 179, 185 (S.D.N.Y. 1992). In their complaint, the plaintiffs alleged that NationsMart's management failed to disclose specific facts indicating that its judgment was flawed. Complaint ¶¶ 41-42. If taken as true, these allegations would call into question whether management was in fact exercising its "best judgment" in formulating the company's financial model, as it claimed in the Prospectus. See Appendix at 597. Because of inadequate and nonspecific warnings of short-term risks, and because of the plaintiffs' allegations that the defendants omitted material information from the Prospectus, the bespeaks-caution doctrine cannot, simply as a matter of pleading, defeat the plaintiffs' § 11 claim.

III.

We also hold that the complaint stated a claim against NationsMart, RAS, and Pauli & Company under § 12(2) of the Securities Act of 1933.

A.

Section 12(2) of the Securities Act of 1933 creates a private remedy for the buyer of a security against the seller for material misrepresentations in connection with the offer and the sale. See 15 U.S.C. § 77*l* (1994). A "seller" of the security is defined as anyone who offers or sells a security "by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication . . . ." 15 U.S.C. § 77*l*(2). Once a buyer can establish privity with a seller, the buyer need prove only that there was a material misstatement or omission in the prospectus or oral communication. The seller's only defense is that he did not know of the false material misstatement and, in the exercise

of due diligence, could not have discovered the misstatement. 15 U.S.C. § 77*l*(2). The plaintiff need not prove reliance on the prospectus or oral statement. *Austin v. Loftsgaarden,* 675 F.2d 168, 176 n.16 (8th Cir. 1992). Fraud and scienter are not elements of a § 12(2) claim. *Wigand v. Flo-Tek. Inc.,* 609 F.2d 1028, 1034 (2d Cir. 1980).

The District Court dismissed the plaintiffs' § 12(2) claim in part because it held that many of the statements in the Prospectus challenged by the plaintiffs were forward-looking and fell into the "safe harbor" of SEC Rule 175, which applies to § 12(2) as well as § 11 of the 1933 Act. See 17 C.F.R. § 230.175 (1997). We hold that the safe harbor rule does not apply to the plaintiffs' § 12(2) claim, as pleaded, for the same reason that it does not apply to the § 11 claim: The plaintiffs adequately pleaded that the defendants had no reasonable basis for the forward-looking statements found in the offering materials. The District Court also dismissed the plaintiffs' § 12(2) claim because it thought that the statements of historical fact, to which the safe-harbor rule does not apply, and allegations of false statements made by the defendants after the date of the offering were not pleaded with sufficient particularity under Federal Rule of Civil Procedure 9(b). But Rule 9(b) does not apply to claims brought under § 12(2) because, as in the case of § 11, proof of fraud and scienter are not necessary for recovery. Any allegations of fraud or scienter by the plaintiffs to sustain the § 12(2) claim were surplusage, and the complaint should not have been dismissed for pleading more than the Federal Rules required.

The District Court also dismissed the plaintiffs' § 12(2) claim on the theory that the Risk Factors stated in the Prospectus "bespoke caution" and warned investors of any potential risks. We hold that the "bespeaks caution" doctrine does not apply to the § 12(2) claim for the same reason that it does not apply to the § 11 claim: The complaint alleges that the Prospectus did not adequately warn investors of short-term risks, and the bespeaks caution doctrine does not apply to the alleged material omissions

from the Prospectus.

B.

The District Court's application of Rule 9(b), SEC Rule 175, and the "bespeaks caution" doctrine did not entirely dispose of the § 12(2) claim. Section 12(2), unlike § 11, imposes liability for misstatements and omissions made after the public offering, as well as those made in the offering materials. Because § 12(2) extends liability beyond the date of the offering, some courts have found a duty to update a prospectus after the offering date if any statements in it become false or misleading over time. See *Ackerman v. Schwartz*, 947 F.2d 841, 848 (7th Cir. 1991) (recognizing a duty to update a prospectus in the context of a claim brought under § 10(b) of the Securities Exchange Act of 1934). The District Court did not have to reach the question of whether NationsMart could be liable under § 12(2) for breach of a duty to update the Prospectus because it dismissed the plaintiffs' § 12(2) claim on the alternative ground that the plaintiffs did not adequately allege that NationsMart was a "seller" of securities under the meaning of § 12(2).[5] A "seller," under § 12(2), is "anyone who successfully solicits the purchase of securities, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." *In re Crafmatic*

[5]The District Court, in its April 11, 1996 order, allowed part of the § 12(2) claim to survive with respect to RAS and Pauli & Company, the two lead underwriters, because they did not dispute that they were "sellers" under § 12(2). The Court allowed the § 12(2) claim to survive against RAS and Pauli & Company to the extent that they may have had a duty to update or correct the Prospectus if it became misleading after the date of the offering, pending briefing by the parties on the issue. In an order filed on November 6, 1996, the District Court dismissed the remaining § 12(2) claim against RAS and Pauli & Company, holding that they had no duty to update any statements which may have become misleading after the date of the offering. Because the plaintiffs do not contest on appeal the District Court's ruling that the two underwriters had no duty to update, we do not need to reach that question now.

Securities Litigation v. Kraftsow, 890 F.2d 628, 635 (3d Cir. 1990) (citing *Pinter v. Dahl*, 486 U.S. 622, 647 (1988)). The District Court recognized that in the consolidated complaint, the plaintiffs alleged that "NationsMart and the Underwriter Defendants offered, sold, and solicited sales of shares, by means of the Prospectus . . . . NationsMart and the Underwriter Defendants were sellers of the shares of NationsMart stock within the meaning of Section 12(2) of the Securities Act." Complaint ¶ 76. The District Court held that the plaintiffs should have alleged specific facts demonstrating that NationsMart actively solicited the sale of shares to the plaintiffs. Once again, the District Court applied the heightened pleading standard of Federal Rule of Civil Procedure 9(b) to a § 12(2) claim, which does not require proof of fraud or mistake for recovery. We disagree, and hold that the plaintiffs adequately alleged in the complaint that NationsMart was a seller under § 12(2).

The defendants argue that the plaintiffs waived the argument on appeal that NationsMart was a seller under § 12(2) because the plaintiffs did not specifically refer to it in their appellate brief. However, the plaintiffs did argue at length that the particularity requirement of Federal Rule 9(b) should not apply to § 12(2) claims. Appellants' Br. at 17-20. We therefore hold that the plaintiffs did not waive the argument that Rule 9(b) did not require the plaintiffs to plead with specificity that NationsMart was a seller under § 12(2).

IV.

For the reasons given below, we uphold the District Court's dismissal of the plaintiffs' claim under §§ 10(b) and 20 of the Securities Exchange Act of 1934 and SEC Rule 10b-5.

A.

Rule 10b-5, promulgated by the SEC pursuant to § 10(b) of the Securities Exchange Act of 1934, prohibits fraudulent conduct

in the sale and purchase of securities. 15 U.S.C. § 78j (1994); 17 C.F.R. § 240.10b-5 (1997); *Harris v. Union Electric Co.*, 787 F.2d 355, 362 (8th Cir.), *cert. denied,* 479 U.S. 823 (1986). Section 20 of the Securities Exchange Act extends liability under § 10(b) and Rule 10b-5 to any "controlling person." 15 U.S.C. § 78t(a) (1994). To recover in a private action brought under Rule 10b-5, a plaintiff must establish:

> 1) that the defendant acted in a manner prohibited by the Rule, whether it be that the defendant employed a device, scheme, or artifice to defraud, made misrepresentations or omissions of material fact, or engaged in acts, practices or courses of business that operate as a fraud or deceit; 2) causation, often analyzed in terms of materiality and reliance; 3) damages; and 4) that the fraudulent activity occurred in connection with the purchase and sale of a security.

Harris v. Union Electric Co., 787 F.2d at 362. Proof of scienter, or the "intent to deceive, manipulate, or defraud," is necessary to prevail in a 10b-5 action. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). Because a Rule 10b-5 claim is necessarily grounded in fraud, the more stringent pleading requirements of Federal Rule of Civil Procedure 9(b) apply to complaints alleging a 10b-5 violation. *Arazie v. Mullane*, 2 F.3d 1456, 1465 (7th Cir. 1993).

The Code of Federal Regulations applies a "safe harbor" rule to Rule 10b-5 which protects forward-looking statements from liability. 17 C.F.R. § 240.3b-6 (1997). This regulation is identical to the regulations which protect forward-looking statements under the Securities Act of 1933. See 17 C.F.R. § 230.175 (1997). As noted above, the plaintiff does not deny that many of the challenged statements from the Prospectus—such as NationsMart's plan to open 108 new stores in 1994 and 600 new stores by 1998, the intended uses of proceeds from the offering,

and predictions about future sales and diminishing operating losses—were forward-looking. Rather, the plaintiffs allege in the complaint that management had no reasonable basis to make such statements. If pleaded properly, these allegations would allow the plaintiffs to avoid the safe-harbor rule.

We agree with the District Court that the plaintiffs' allegations that the forward-looking statements were made without a reasonable basis do not conform to the particularity requirements of Federal Rule 9(b). In the complaint, the plaintiffs allege that management's business plan was "false and misleading and not reasonably based"; that sales forecasts "were not justifiable or reasonable based on historical data"; and that "there were no valid assumptions underlying the [future business] projections." Complaint ¶¶ 30, 31. While these statements are "short and plain" enough for Federal Rule 8(a), and therefore are sufficient to avoid the safe-harbor rule for the §§ 11 and 12(2) claims, they do not include enough particular facts to show management's allegedly fraudulent statements lacked a reasonable basis. To satisfy Rule 9(b), the plaintiffs should have alleged, for example, who prepared the relevant figures and projections, when they were prepared, and who reviewed and evaluated the figures. See *Arazie v. Mullane*, 2 F.3d at 1465-67. Because the complaint does not provide that level of specificity, the District Court properly dismissed the 10b-5 claim as to the challenged forward-looking statements in the Prospectus.

We also agree with the District Court that the plaintiffs' attempts to state a 10b-5 claim with respect to false statements of historical fact in the Prospectus, which are not covered by the safe-harbor rule, fall short of Federal Rule 9(b)'s specificity requirements. In the complaint, the plaintiffs allege some misstatements of fact, such as that NationsMart' s management misrepresented negative business trends, misrepresented the costs of opening new stores, and omitted material information about the operation of NationsMart stores. Complaint ¶¶ 31, 33,

37, 41, 42. The plaintiffs did not quantify these business trends or say which business trends were described inaccurately in the prospectus. They did not demonstrate how the actual cost of opening a new store differed from the cost found in the prospectus. And the plaintiffs did not plead specific facts showing how omissions from the prospectus were material. See *In re GlenFed Inc. Securities Litigation*, 42 F.3d 1541, 1548 (9th Cir. 1994) (holding that a "plaintiff must set forth what is false or misleading about [a] statement, and why it is false"); *Shushany v. Allwaste Inc.*, 992 F.2d 517, 522 n.9 (5th Cir. 1993) (holding that a plaintiff must state facts showing that a false representation is material). Therefore, the statements of historical fact also did not comply with Federal Rule 9(b) and were properly dismissed.

Because some courts have found a duty to update and correct projections in offering materials to the extent they become materially misleading over time, the District Court recognized that the safe-harbor rule would not foreclose liability under Rule 10b-5 if the defendants in this case had such a duty. And the Court noted that the plaintiffs alleged that NationsMart's directors and officers made false and misleading statements after the date of the offering, which also would not have been covered by the safe harbor rule. The Court disposed of both of these issues by holding that the plaintiffs failed adequately to plead reliance, which is a necessary element of recovery under Rule 10b-5. *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988).

Reliance typically requires plaintiffs to prove that alleged misrepresentations induced them to do something different from what they would otherwise have done in making investment decisions. *Austin v. Loftsgaarden*, 675 F.2d 168, 177 (8th Cir. 1982). In some situations, courts may presume reliance. In a case involving a failure to disclose information to investors, courts will presume reliance if the omitted information is shown to be material. *Affiliated Ute Citizens v. United States*, 406 U.S. 128,

153-54 (1972); *Austin v. Loftsgaarden*, 675 F.2d at 177. The presumption of reliance in failure-to-disclose cases has been limited to situations where the parties deal directly with one another in face-to-face transactions. See *Laventhall v. General Dynamics Corp.*, 704 F.2d 407, 413 n.4 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983). Reliance may also be presumed under a fraud-on-the-market theory, "where materially misleading statements have been disseminated into an impersonal, well-developed market for securities . . . ." *Basic Inc. v. Levinson*, 485 U.S. at 247. Some courts recognize a "fraud-created-the-market" theory, where reliance may be presumed if the defendants' fraudulent activity is "so pervasive that it goes to the very existence of the [securities] and the validity of their presence on the market." *Ross v. Bank South, N.A.*, 885 F.2d 723, 729 (11th Cir. 1989), *cert. denied*, 495 U.S. 905 (1990). Not all courts have accepted the fraud-created-the-market theory. See *Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1130 (7th Cir. 1993), *cert. denied*, 510 U.S. 1073 (1994).

We agree with the District Court that the plaintiffs failed to plead reliance in accordance with the specificity requirements of Federal Rule 9(b). The complaint explicitly mentioned reliance only once:

> Plaintiffs and other members of the Class, at the time of the alleged misrepresentations and omissions, were ignorant of the falsity of the statements, and believed them to be true. In reliance upon the defendants' misrepresentations, the integrity of the market and the securities offering process, and upon the fidelity, integrity and superior knowledge of the defendants, and in ignorance of truth, plaintiffs and the other Class members were induced to and did obtain NationsMart securities. Had plaintiffs and the other members of the Class known the truth, they would not have taken such action.

Complaint ¶ 88. The plaintiffs did not adequately plead actual reliance, because they did not allege specific facts showing that they relied on the prospectus or any post-offering statements by the defendants. They did not claim that they ever read the prospectus or specify which allegedly fraudulent statements they relied on in purchasing NationsMart stock.

The plaintiffs also failed properly to invoke any of the presumptions of reliance. The complaint alleged no direct contact between the plaintiffs and the defendants, so the plaintiffs are not entitled to the presumption of reliance for the non-disclosure of material information. As for the fraud-on-the-market theory, though the complaint mentioned that NationsMart stock was traded on the NASDAQ market, it did not allege specific facts showing that a large number of people could buy or sell the stock; that trading information on the stock was widely available; and that the market rapidly reflected new information in price. See *Freeman v. Laventhold & Horwath*, 915 F.2d 193, 199 (6th Cir. 1990). Finally, even if this Court were to accept the "fraud-created-the-market" theory, the plaintiffs do not allege facts indicating that if the defendants had not made fraudulent statements, there would not have been any market for NationsMart securities. Therefore, because the plaintiffs do not plead reliance specifically as required by Rule 9(b), the District Court properly dismissed the allegations under Rule 10b-5 that the defendants had a post-offering duty to update material misstatements and the claim that the defendants made fraudulent statements after the date of the offering.

B.

Because the plaintiffs failed to state a claim under § 10(b) of the Securities Exchange Act in their complaint, it is necessary to determine whether the district judge abused her discretion in denying the plaintiffs' request for leave to amend to correct defects in the complaint. We hold that the judge did not abuse her discretion in denying leave to amend.

A review of the procedural history of the case is necessary to explain our holding. On July 17 and July 20, 1995, the defendants filed various motions to dismiss the plaintiffs' consolidated complaint. As the District Court explained in its November 6, 1996, order, the basis of many of these motions was the failure to plead fraud with particularity under Rule 9(b). Therefore, as early as July 1995, the plaintiffs were on notice that the sufficiency of their pleadings was being attacked by the defendants. On July 31, 1995, the District Court issued a pretrial order which set September 30, 1995, as the last day for amendments to pleadings. Over the next few months, the plaintiffs made no attempt to remedy the defects in the complaint claimed by the defendants, and made no request of the District Court that they be allowed to amend if the Court granted the defendants' motions to dismiss. On April 11, 1996, the district judge granted the defendants' motions to dismiss in large part. Two weeks later, the plaintiffs filed a motion to vacate the April 11 order and a motion seeking leave to amend the complaint. The district judge denied this motion on November 6, 1996.

The applicable standard of review is whether the District Court abused its discretion in denying leave to amend. *Buder v. Merrill Lynch, Pierce, Fenner & Smith*, 644 F.2d 690, 694 (8th Cir. 1981). Typically, in keeping with the policy of Federal Rule of Civil Procedure 15(a), leave to amend pleadings should be liberally granted. *Foman v. Davis*, 371 U.S. 178, 182 (1962); *Buder*, 644 F.2d at 694. However, different considerations apply when a party seeks to amend the pleadings *after* the district court dismisses the complaint. *United Food and Commercial Workers International Union v. Brown Group. Inc.*, 50 F.3d 1426, 1432 (8th Cir. 1995), *rev'd on other grounds*, 116 S. Ct. 1529 (1996). While the district court, in its discretion, may still grant leave to amend after it dismisses a complaint, unexcused delay by the plaintiff in seeking to amend is sufficient to justify the court's denial. *Humphreys v. Roche Biomedical Laboratories, Inc.*, 990 F.2d 1078, 1082 (8th Cir. 1993).

Given that the plaintiffs had nearly ten months between the time they were put on notice and the time the District Court dismissed most of the counts in the complaint, we cannot say that the District Court abused its discretion in denying leave to amend after its April 11 order. The plaintiffs cite as their primary reason for delay their inability to obtain discovery from the defendants; yet, in their brief, they admit that they were receiving new information throughout late 1995 and early 1996 which they eventually used in the amended complaint filed on April 25. Appellants' Br. at 36. At the very least, before the April 11 dismissal, the plaintiffs could have requested leave to amend in the event the District Court found the defendants' 9(b) arguments persuasive. Because the plaintiffs waited until two weeks after the dismissal of most of their case to attempt to remedy problems of which they were aware months before, we uphold the denial of leave to amend and the District Court's dismissal of the plaintiffs' Rule 10b-5 claim. The Court could well have granted leave to amend, but we cannot say it was obliged to do so.

V.

For the reasons discussed above, we affirm the judgment of the District Court in part, reverse in part, and remand for further proceedings not inconsistent with this opinion.

BEAM, Circuit Judge, concurring and dissenting.

I concur in Parts I, II A and B and IV A and B of the court's opinion. As to Parts II C and III A and B, I dissent. It is difficult for me to envision how or in what manner, defendants could have advanced greater warnings to potential investors so as to avail themselves of the "bespeaks caution" doctrine. Accordingly, I would affirm the district court under that holding.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS,
EIGHTH CIRCUIT.

APPENDIX B

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

Cause No. 4:94CV2182 JCH

In re: NationsMart Corporation
Securities Litigation

This Document Relates To:
All Actions

MEMORANDUM AND ORDER

This matter is before the Court on Defendants' motions to dismiss and the Motion of Non-Party The Source Company to Quash Subpoena.

The Court first addresses a potential conflict of interest issue raised *sua sponte* in its March 8, 1996 Order, in which the Court ordered the Gallop, Johnson law firm to demonstrate the propriety of its representation of Defendants NationsMart, Alan G. Johnson, and NationsMart's remaining directors. The Court also ordered the Thompson, Mitchell law firm to demonstrate the propriety of its representation of Defendants RAS Securities Corporation and Pauli & Company. Both law firms have demonstrated to the Court's satisfaction that no conflict of interest is present at this time. Plaintiffs do not seek to disqualify either law firm.

DEFENDANTS' MOTIONS TO DISMISS

Defendants have filed six separate motions to dismiss Plaintiff's Consolidated Amended Class Action Complaint for failure to state a claim and/or failure to allege fraud with particularity. Fed. R. Civ. P. 12(b)(6), 9(b). In passing on a 12(b)(6) motion, a court

must view the allegations in the complaint in the light most favorable to the plaintiff. *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974). A cause of action should not be dismissed for failure to state a claim unless, from the face of the complaint, it appears beyond a reasonable doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief. *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957); *Jackson Sawmill Co. v. United States*, 580 F.2d 302, 306 (8th Cir. 1978), *cert. denied*, 439 U.S. 1070 (1979).

Rule 9(b) provides, "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Fed. R. Civ. P. 9(b). "'Circumstances' include such matters as the time, place, and contents of false representations, as well as the identity of the person making the misrepresentation and what was obtained or given up thereby." *Bennett v. Berg*, 685 F.2d 1053, 1062 (8th Cir. 1982), *on reh'g*, 710 F.2d 1361 (8th Cir.), *cert. denied*, 464 U.S. 1008 (1983), citing 2A J. Moore & J. Lucas, Moore's Federal Practice ¶ 9.03 at 9-19–9-24 (1982). *Accord St. Louis Home Insulators, Inc. v. Burroughs Corp.*, 597 F. Supp. 100, 101 (E.D. Mo. 1984), *aff'd*, 793 F.2d 954 (8th Cir.), *cert. denied*, 479 U.S. 1021 (1986).

The Court may consider any document in the public domain, including a prospectus filed with the Securities and Exchange Commission, on a motion to dismiss, without converting the motion into one for summary judgment, if that document is the subject of the complaint. *In re Donald J. Trump Casino Securities Litigation*, 7 F.3d 357, 368 n.9 (3d Cir. 1993), *cert. denied*, 114 S.Ct. 1219 (1994); *Kramer v. Time Warner. Inc.*, 937 F.2d 767, 773-74 (2d Cir. 1991); *I. Meyer Pincus & Assoc. v. Oppenheimer & Co., Inc.*, 936 F.2d 759, 762 (2d Cir. 1991); *Nielsen v. Greenwood*, 849 F.Supp. 1233, 1248-49 (N.D. Ill. 1994); *In re Browning-Ferris Industries, Inc. Shareholder Derivative Litigation*, 830 F.Supp. 361, 367 n.2 (S.D. Tex. 1993), *aff'd*, 20 F.3d 465 (5th Cir. 1994); *CIRO, Inc. v. Gold*, 816

F.Supp. 253, 257 (D. Del. 1993). Plaintiffs do not challenge this point.

Facts

Viewing the record in the light most favorable to Plaintiffs, the Court finds that the following facts are established. Defendant NationsMart Corporation ("NationsMart" or "the Company") is a Missouri corporation with its principal place of business in St. Louis. NationsMart, which began operations in 1992, manages retail dry cleaning, laundry, and shoe repair centers in Wal-Mart, Kmart, and other large national retail stores.

On December 22, 1993, pursuant to a Registration Statement and Prospectus filed with the Securities and Exchange Commission (SEC), NationsMart commenced an initial public offering of two million units at a price of $7.00 per unit. Name Plaintiff Jack Carlson represents a class of persons ("Class A") who purchased NationsMart securities in the offering and suffered damage as a result. (Nov. 22, 1995 Order Certifying Classes, ¶1). Name Plaintiff Helen Palmquist represents a class of persons ("Class B") who purchased NationsMart securities in the offering or in the open market during the period December 22, 1993 through August 18, 1994 and suffered damage as a result. (*Id.*, ¶2).

Defendant Michael Thaman was the President, Chief Executive Officer, and a director of NationsMart from the time of the offering until June 17, 1994. Defendant Alice Brueggemann was the Senior Vice President, Treasurer, and Chief Financial Officer of NationsMart from the time of the offering until her termination on March 8, 1994. Defendant S. Leslie Flegel was the Chairman of the Executive Committee and a director of NationsMart. Defendant Mel Friedman was the Executive Vice President and a director of NationsMart. Defendant Alan G. Johnson, a senior partner with the Gallop, Johnson law firm,

served as Secretary and a director of NationsMart. Defendant Franklin Jacobs was an Executive Committee member and a director of NationsMart. Defendant S. Lee Kling was an Executive Committee member and a director of NationsMart, and served as Chairman of the Board until June, 1993. Defendant Michael Dunlap was NationsMart's Controller and Principal Accounting Officer.

Defendant RAS Securities Corp. ("RAS"), a New York corporation, and Defendant Pauli & Company, Inc. ("Pauli"), a Missouri corporation, were the lead underwriters for the offering. Defendants ABD Securities Corporation, et al., originally named as Defendants in Cause No. 4:95CV1274 DDN, which was consolidated with the instant action on July 13, 1995, were the 25 additional underwriters for the offering.

The Prospectus for NationMart's initial public offering contains the following information.[1] Page one briefly describes the terms of the offering and explains that there was no public market for NationsMart securities prior to the offering. Page one further notes that the securities are to be offered by "the several Underwriters." (Prospectus, at 1). Finally, in the middle of page one, in bold capital letters, appears the following statement:

> **THE SECURITIES OFFERED HEREBY ARE SPECULATIVE AND INVOLVE A HIGH DEGREE OF RISK AND IMMEDIATE SUBSTANTIAL DILUTION. SEE "RISK FACTORS" AND "DILUTION."**

(*Id.*).

The Prospectus Summary states that NationsMart opened 44 retail service centers ("Centers") in Wal-Mart stores and 7

[1]The Prospectus is attached as Exhibit A to Defendants' Memorandum in Support of their Motion to Dismiss all Claims Based on Allegations Other than Prospectus Allegations [docket #40].

Centers in Kmart stores since June, 1992. The Summary further notes that 60 new Wal-Mart stores and 53 new Kmart stores had allotted space for future Centers. The Summary continues,

> Based on Wal-Mart's and Kmart's announced expansion plans and on assignments received to date, the Company plans to open a total of 600 additional Centers on various dates from 1994 through 1998, and a portion of the proceeds of this offering will be used to fund the opening of 108 of the Centers. However, the actual number of stores which will be opened by the Company is dependent on numerous factors, many of which are outside the Company's control, including the Company's ability to expand as required to accommodate space assigned to the Company by the host retailers.

(*Id.* at 3). Essentially the same statement appears repeatedly throughout the Prospectus. (*Id.* at 10, 15, 18, 20).

NationsMart expected to receive approximately $11.7 million in net proceeds as a result of the offering. (*Id.* at 11). The Company anticipated that such proceeds would be used to fund

> (i) approximately $4.1 million in capital expenditures associated with the opening of 108 additional Centers anticipated to be opened before November 1994, primarily in Wal-Mart Supercenters and Super Kmart Centers, (ii) approximately $4.0 million in expenses associated with the operation of the approximately 159 Centers anticipated to be open by such date and (iii) approximately $3.6 million payable to redeem its 10% redeemable subordinated notes (the "Notes"), approximately $450,000 principal balance of which is payable to directors, officers and employees of the Company.

(*Id.*). The Prospectus further states, "The Company believes that the net proceeds of this offering will be sufficient to accomplish the purposes for which such net proceeds are expected to be used." (*Id.*).

Plaintiffs allege that the Company's representations regarding its business plan through October 1994 were "false and misleading and not reasonably based." (Compl., ¶¶22, 30).[2] According to Plaintiffs, "Defendants knew that the sales forecasts upon which the statements were based were not justifiable or reasonable based on historical data." (*Id.*, ¶30). Plaintiffs do not explain how the sales forecasts were not justifiable or reasonable, and they do not provide examples of the pertinent historical data. Plaintiffs further allege,

> At the time of the Offering and shortly thereafter, defendants were in possession of, or had access to, projections prepared by the Underwriter Defendants. The underwriters' projections conclusively demonstrated that NationsMart would be unable to fulfill its business plan even with the proceeds of the Offering. The underwriters' projections further demonstrated that the cash flow from NationsMart's existing locations and those to be opened in the first quarter of 1994 would be insufficient to allow for continued expansion of locations in Wal-Mart and K-Mart stores.

(*Id.*). NationsMart's directors allegedly rejected the underwriters' projections and directed the underwriters to use "baseless new projections" in the offering materials. (*Id.*, ¶31). Plaintiffs do not provide any details concerning the underwriters' original projections or the "baseless new projections."

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[2] The Court will use the abbreviation "Compl." to refer to the Consolidated Amended Class Action Complaint.

Plaintiffs contend that the "Risk Factors" section of the Prospectus discloses in only a "general and summary fashion" some risks inherent in NationsMart's planned expansion. (*Id.*, ¶27). "However," Plaintiffs allege, "the Prospectus was extremely upbeat about NationsMart's prospects, touting the 'proved' and 'tested' nature of the NationsMart formula, and conveying the impression that the major risk faced by NationsMart was that so many K-Mart and Wal-Mart 'host' locations would open that they would outrun NationsMart's ability to keep pace." (*Id.*).

The Court disagrees with Plaintiffs' characterization of the "Risk Factors" section, which takes up five pages of the Prospectus. The first sentence of the section warns,

> Investment in the Units offered hereby is speculative and involves a high degree of risk. Prospective investors should give careful consideration to the following factors before making an investment in the Units offered hereby. The investment is not appropriate for those who cannot bear the risks described below.

(Prospectus, at 6). Each risk factor is highlighted in bold print.

Under the first factor, **"Ability to Continue as a Going Concern,"** the Prospectus notes in pertinent part,

> The Company's recurring operating losses and limited capital resources have caused the Company's independent accountants to issue a report which indicates that substantial doubt exists as to the Company's ability to continue as a going concern. The Company anticipates that absent completion of this offering it would likely exhaust its capital resources in January 1994 and that full implementation of its business plan for establishment of additional Centers and the opera-

> tions of existing Centers after October 1994 will require capital resources in addition to those provided by the proceeds of this offering . . . . [T]he Company has no definitive arrangements to obtain additional funding.

(*Id.*). Later on in the Prospectus, as Plaintiffs note (Compl., ¶¶26, 38), the Company discounts the impact of its accountants' going concern qualification:

> Based upon its financial model, management believes that previously experienced operating losses will diminish as currently operating Centers, most of which have been open fewer than six months, begin to generate income from operating activities. Additionally, the net proceeds of this offering will significantly improve the capital resources of the Company and thereby address certain of the going concern conditions. Management further believes that as operating losses diminish and the number of operating Centers increases, additional external sources of capital will become more readily available to the Company. Accordingly, management considers the conditions which resulted in questions about the Company's ability to continue as a going concern to be transitory. However, the financial model used by the Company reflects only the best judgment of management and actual results are substantially dependent on numerous factors, many of which are outside the Company's control; accordingly, there can be no assurance that the results indicated by its financial model will be achieved.

(Prospectus, at 19).

The second risk factor is entitled, **"Limited Operating History; Accumulated Deficit; Future Operating Losses."** (*Id.* at

6). In this paragraph the Company notes that it has only a "limited business history" and that it is "vulnerable to a variety of business risks generally associated with an early stage, rapidly growing company." (*Id.*). The Prospectus mentions several negative trends, including net losses, negative cash flow, and accumulated deficits, and notes that net losses and negative cash flow were expected to continue in 1994 and 1995. (*Id.*). "Continued implementation of the Company's present business plan," the paragraph concludes, "is dependent upon its ability to continue to fund such operating losses through external sources of financing, such as this offering." (*Id.*).

Under the third risk factor, **"Rapid Growth; Future Need for Additional Financing,"** the Company notes its vulnerability to "a variety of risks associated with rapid growth, including the Company's ability to attract and retain qualified personnel, integrate new Centers into the Company's operations, and the availability of adequate external sources of financing." (*Id.*). The Company explains that the offering is not intended to "provide funds for unforeseen general corporate purposes." (*Id.*). NationsMart's ability to attract additional financing would depend in part on its "ability to achieve significant sales growth, profitability and positive cash flow from operations," the Prospectus notes, and such financing could not be guaranteed. (*Id.* at 6-7). The succeeding three pages of the Prospectus discuss in detail 13 other risk factors, which are less relevant to the present case. (*Id.* at 7-10).

According to Plaintiffs, immediately before the offering Defendants were aware of "a variety of adverse facts concerning NationsMart's performance, including that there were no favorable revenue, profit and expense trends as described in the Prospectus," and that "projected trends were not materializing and were not likely to materialize . . . ." (Compl., ¶41). Plaintiffs do not specify which "favorable trends" they have in mind, nor do they acknowledge the Company's substantial disclosure of

negative trends in the "Risk Factors" section. Plaintiffs further allege that "NationsMart had no site selection strategy, other than to open a Center willy-nilly wherever and whenever a new Wal-Mart Supercenter or Super Kmart opened, . . . and that the Company was routinely breaking the law and entering into 'sweetheart' deals with affiliates of NationsMart's officers and directors." (*Id.*). These allegations are not elaborated any further.

During the months preceding the offering, Plaintiffs allege, "many, if not most, significant indicators of NationsMart's performance and future success were on a steep downward slope. . . ." (*Id.*, ¶42). As examples Plaintiff cite the following:

> (a) the amount of time which defendants believed a store had to operate before becoming profitable had continually increased significantly, i.e., the expected "break-even" date for a store had been extended and was becoming even more distant;
>
> (b) the amount of money needed to open and subsidize a Center until it became profitable had increased substantially and was continuing to increase;
>
> (c) the cost to operate existing Centers had increased substantially;
>
> (d) corporate overhead was ballooning, and despite the Prospectus' statements to the effect that as of the end of September, 1993, the Company had substantially completed the "infrastructure" needed to carry the Company forward without substantial additional expenditures in this regard, NationsMart spent almost as much in the last three months of 1993 as it had in all of the preceding nine months;
>
> (e) While the Prospectus states that the defendants expected corporate overhead as a percentage of net

> sales to decline, they knew by the Effective Date that the percentage of corporate overhead to net sales had not declined appreciably. Indeed, except for a brief section of the first quarter of 1994, corporate overhead as a percentage of net sales had increased, from 76% (as disclosed in the Prospectus) to 83% (as disclosed in the Company's 10-Q for the second quarter of 1994, page 2); and
>
> (f) the Company's "burn rate," or the rate at which it used up its capital, had skyrocketed. The Prospectus disclosed that the Company would be out of money in January, 1994, absent the Offering. It did not disclose the exponential increase in expenses and costs which had put it in that position. Nor did it disclose the lack of any realistic prospect that the situation would improve after the Offering.

(*Id.*). Plaintiffs fail to provide any detail supporting these conclusory allegations.

Defendant Alice Brueggemann, then NationsMart's Chief Financial Officer, allegedly told Defendants Thaman, Kling, Johnson, and Jacobs in January, 1994 that:

> i) purported sales forecasts set forth in the Prospectus were baseless and falsely optimistic . . .; ii) Thaman had been "burying" loans to friends in false financial statements; iii) NationsMart books and records had been altered; iv) NationsMart was wilfully violating the Fair Labor Standards Act ("FLSA"), a crime under 29 U.S.C. § 216(a); and v) certain affiliated party dealings were unfair to NationsMart.

(*Id.*, ¶53). Ms. Brueggemann shared these allegations in a formal meeting with Defendant Kling on January 24, 1994. (*Id.*, ¶54).

NationsMart's directors allegedly refused to revise the Registration Statement to reflect Ms. Brueggemann's disclosures. (*Id.*).

On March 8, 1994 NationsMart's Board of Directors terminated Ms. Brueggemann's employment. (*Id.*). Ms. Brueggemann filed suit against NationsMart and its directors in June, 1994, thereby publicizing many of the foregoing allegations. (*Id.*, ¶53). The suit was settled quickly, subject to strict confidentiality agreements. (*Id.*).

In early March, 1994 "NationsMart announced expansion plans which overshadowed the report of a net loss for the quarter." (*Id.*, ¶44). In late March, Defendant Thaman stated that the Company planned to open 80 to 85 stores that year, and that sales "should grow five to six times." (*Id.*, ¶45). Plaintiffs allege that this statement was "materially misleading when made, having no reasonable basis in fact." (*Id.*). However, they do not explain why the statement had no reasonable basis.

In early April, NationsMart filed with the SEC its Annual Report on Form 10-K, announcing its intention to open 114 stores in fiscal year 1994. (*Id.*, ¶47). The Company also acknowledged, however, that 20 percent of the Centers would be closed for underperformance. (*Id.*, ¶48). NationsMart filed with the SEC a post-effective amendment to the Registration Statement, containing revised financial data; however, the Company did not supplement or "sticker" the Prospectus. (*Id.*).

On May 9, 1994 NationsMart reported a net loss of 29 cents per share for the first quarter of 1994, as compared to net loss of 10 cents per share for the first quarter of 1993. (*Id.*, ¶49). Defendant Thaman stated, however, that the losses were within the Company's expectations given the speed of its growth. (*Id.*). He represented that NationsMart would open about 75 of the 107 Center locations offered to the Company by Wal-Mart and Kmart stores. (*Id.*).

The Company issued its Quarterly Report on Form 10-Q on May 16, 1994. The report predicted that some of the newer Centers would begin to generate income within the next year, and that "additional external sources of capital" would "become more readily available to the Company." (*Id.*, ¶50). The report continued,

> Accordingly, management expects that the conditions which resulted in concerns about the Company's ability to continue as a going concern will be alleviated in the future. . . . However, the financial model used by the Company reflects only the best judgment of management and actual results are substantially dependent on numerous factors, many of which are outside the Company's control, accordingly, there can be no assurance that the results indicated by its financial model will be achieved.

(*Id*). According to Plaintiffs, the foregoing statement was false and misleading, "because defendants knew that their financial model was based on assumptions that were unreasonable in light of historical data." (*Id.*). Plaintiffs provide none of this historical data to the Court.

The Company began a reorganization process in June, 1994. Defendant Thaman was replaced by Charles Goorman as Chief Executive Officer. Mr. Goorman announced that the Company was considering selling franchises as a means of raising capital. (*Id.*, ¶52). Defendant Flegel stated on July 9 that, "We think we have things well under control" (*Id.*, ¶55). On July 14 the Company announced that it would open 35 to 45 fewer stores than anticipated in 1994, and that "it was experiencing slower than anticipated growth in its stores." (*Id.*, ¶56).

On August 17, 1994 NationsMart filed its Form 10-Q report for the second quarter. The report revealed that only $2.6 million of the $11.4 million raised in the offering remained to be spent.

(*Id.*, ¶58). The net loss had risen from 29 cents to 49 cents per share. (*Id.*). The report identified the source of the losses as "expenses associated with opening new retail dry cleaning. . . units. . . in. . . K-Mart stores. . . ." (*Id.*, ¶59). On August 18, 1994, the *St. Louis Post Dispatch* reported the Company's $2.7 million net loss for the quarter and its decision to attempt to sell franchises. (*Id.*, ¶60).

NationsMart reported continued losses in its third quarter 10-Q form. "While these losses are not inconsistent with management's initial expectations," the report noted, "the negative cash flow associated with the losses has put a burden on the Company's ability to open planned Centers for the balance of 1994." (*Id.*, ¶62). The Company decided to open only 10 of the Centers allotted to it by Wal-Mart stores by the end of 1994. (*Id.*). As a result of the foregoing disclosures, the price of NationsMart securities fell from $7.00 at issuance to $1.25 as of October 19, 1994. (*Id.*, ¶63)

The Consolidated Amended Class Action Complaint contains three counts. Count I asserts that all of the Defendants are liable under §§ 11 and 15 of the Securities Act of 1933, 15 U.S.C. §§77k(a), 77(o), for filing a registration statement which contains false or misleading statements or omissions. Count II alleges that NationsMart and the underwriter Defendants are liable under § 12(2) of the Securities Act, 15 U.S.C. § 77*l*(2), for offering or selling securities by means of a prospectus which contains false or misleading statements. Count III alleges that all of the Defendants are liable under §§ 10b and 20 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78j(t), and Rule 10b-5, for making false or misleading statements or omissions in connection with the sale of securities. The Class A Plaintiffs assert Counts I and II, and the Class B Plaintiffs assert Count III.

Defendants have filed six motions to dismiss. Several of the motions seek dismissal of various "allegations" of the Consoli-

dated Amended Class Action Complaint, rather than of the counts contained therein. All Defendants, for example, move to dismiss "claims based on projections of future performance." [docket #39]. NationsMart and most of its directors join in a "Motion to Dismiss Claims Based on Allegations Other than Prospectus Projections." [docket #40]. Defendant Brueggemann seeks dismissal of Counts I and III in their entirety, and the additional underwriters request dismissal of the entire Consolidated Amended Class Action Complaint as beyond the statute of limitations. Rather than address each argument raised by Defendants, the Court will discuss the sufficiency of each count as to each Defendant, drawing on the Defendants' briefs as necessary.

Count I - §§ 11 and 15 of the Securities Act

Section 11 of the Securities Act of 1933 provides in pertinent part:

> (a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security. . . may, either at law or in equity, in any court of competent jurisdiction, sue —
>
> > (1) every person who signed the registration statement;
> >
> > (2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
> >
> > (3) every person who, with his consent, is named in the registration statement as being or about to

> become a director, person performing similar functions, or partner;
>
> * * *
>
> (5) every underwriter with respect to such security.

15 U.S.C. § 77k(a). Section 15 of the Securities Act extends liability under § 11 to any person who, by virtue of stock ownership or otherwise, controls any person liable under § 11. 15 U.S.C. § 77o.

Forward-Looking Statements

Chapter 17 of the Code of Federal Regulations creates a "safe harbor" for "forward-looking statements" contained in documents filed with the SEC. 17 C.F.R. § 230.175. Any of the following qualify as forward-looking statements:

> (1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;
>
> (2) A statement of management's plans and objectives for future operations;
>
> (3) A statement of future economic performance contained in management's discussion and analysis of financial condition and results of operations. . .; or
>
> (4) Disclosed statements of the assumptions underlying or relating to any of the statements described in paragraphs (c)(1), (2), or (3) of this section.

Id., § 230.175(c). A forward-looking statement "which is made by or on behalf of an issuer. . . shall be deemed not to be a fraudulent statement. . ., unless it is shown that such statement

was made or reaffirmed without a reasonable basis or was disclosed other than in good faith." *Id.*, § 230.175(a).

A forward-looking statement is actionable under the securities laws to the extent that 1) it is not genuinely believed, 2) the statement lacks a reasonable basis, or 3) the speaker knows of undisclosed facts seriously undermining the accuracy of the statement. *In re Apple Computer Securities Litigation,* 886 F.2d 1109, 1113 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990). To avoid the safe harbor, a plaintiff must plead and prove specific facts demonstrating one or more of these three factors. *Arazie v. Mullane,* 2 F.3d 1456, 1467 (7th Cir. 1993); *Roots Partnership v. Lands' End, Inc.*, 965 F.2d 1411, 1418 (7th Cir. 1992).

Most of the statements challenged by Plaintiffs in Count I are forward-looking statements. The statement that NationsMart planned to open 108 new Centers by 1994 and 600 Centers by 1998, qualifies as a "statement of management's plans and objectives for future operations." 17 C.F.R. § 230.175(c)(2). The Company's representation that it believed the offering proceeds would be sufficient to cover the intended uses of the proceeds falls within the category of statements "containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items." *Id.*, § 230.175(c)(1). The Company's predictions that operating losses would diminish, that the offering proceeds would improve its capital resources, and that the Company would be able to attract additional capital, likewise qualify as statements "containing a projection of revenues, income. . ., [or] capital structure. . . ." *Id.* Plaintiffs do not contest that the foregoing are forward-looking statements.

Instead, Plaintiffs assert that the foregoing projections "were unreasonable, in bad faith and that defendants knew them to be impossible to achieve." (Pltfs' Mem. in Opp. to Defts' Mtns. to Dismiss, at 10). According to Plaintiffs, paragraphs 30, 31, 41,

53, and 54 of their Consolidated Amended Class Action Complaint set forth "compelling facts showing that the projections made by defendants did not have a reasonable basis when made and that there were undisclosed facts which undermined the accuracy of the forecasts." (*Id.*).

In paragraphs 30 and 31, Plaintiffs allege that Defendants knew before the offering that their business plan could not be achieved, because "the sales forecasts upon which the statements were based were not justifiable or reasonable based on historical data." (Compl., ¶30). Plaintiffs also allege that NationsMart and its directors rejected the underwriters' projections and substituted "materially more optimistic," "baseless" projections in the offering materials. (*Id.*, ¶¶30, 31). The foregoing allegations are insufficient under Rule 9(b). Like the plaintiffs in *Arazie,* Plaintiffs in the present case have failed to allege "who prepared the projected figures, when they were prepared, how firm the numbers were, or which. . . [NationsMart] officers reviewed them." 2 F.3d at 1467.

In paragraph 41, Plaintiffs assert that immediately before the offering, Defendants became aware of "a variety of adverse facts concerning NationsMart's performance, including that there were no favorable revenue, profit and expense trends as described in the Prospectus; that projected trends were not materializing and were not likely to materialize; that NationsMart had no site selection strategy. . .; and that the Company was routinely breaking the law and entering into 'sweetheart' deals with affiliates of NationsMart's officers and directors." (*Id.*, ¶41). Plaintiffs fail to describe with particularity the "adverse facts concerning NationsMart's performance." They fail to cite any particular portion of the Prospectus which falsely describes a revenue, profit, or expense trend as favorable. They do not explain the specific facts supporting their claim that projected trends were not materializing. Finally, they fail to allege what laws the Company was breaking, and to describe which sweet-

heart deals they have in mind and to explain why these deals were unfair to NationsMart.[3]

As Plaintiffs note, several courts have refused to dismiss complaints alleging "material problems that undermine the basis for projections or knowledge by defendants of the unreasonableness of the projections." (Pltfs' Mem. in Osp. to Defts' Mtns. to Dismiss, at 10). However, the factual allegations in these cases contained sufficient detail to satisfy Rule 9(b). *See Cosmas v. Hassett,* 886 F.2d 8, 12 (2d Cir. 1989) (reversing dismissal of complaint where plaintiffs alleged that company fraudulently identified tne People's Republic of China as a major buyer of its products, despite fact that China had imposed severe import restrictions); *Robbins v. Moore Medical Corp.*, 788 F.Supp. 179, 185 (S.D. N.Y. 1992) (corporation characterized target corporation as healthy, despite directors' knowledge that target corporation had experienced "insurmountable problems involving its inventory, utilization of production capacity, and product quality and FDA regulation"); *In re Newbridge Networks Securities Litigation,* 767 F.Supp. 275, 279 (D. D.C. 1991) (corporation failed to reveal "problems with product quality and market acceptance," the risky nature of its research and development activities, and the increasing expenses of its infrastructure, and it provided false explanation of problems with accounts receivable); *Alfus v. Pyramid Technology Corp.*, 764 F.Supp. 598, 603-04 (N.D. Cal. 1991) (company failed to disclose "serious and persistent problems" with development of new product on which company had relied by significantly increasing its fixed

[3] Although Plaintiffs do not say so in their brief, it is possible that paragraph 42 of the Consolidated Amended Class Action Complaint is intended to provide factual support for paragraph 41. Paragraph 42 states that in the months preceding the offering, most indicators of NationsMart's performance were on a "steep downward slope." (Compl., ¶42). Although Plaintiffs list six indicators, they fail to provide any factual detail supporting their conclusory assertions that the indicators were declining. (*Id.*).

overhead and extending its firm financial commitments). The allegations in the present case fall far short of Rule 9(b)'s requirements.

Plaintiffs also rely on paragraphs 53 and 54 for their assertion that the Company's projections lacked a reasonable basis. In these paragraphs Plaintiffs state that Defendant Alice Brueggemann filed her lawsuit against NationsMart on June 27, 1994, alleging that she told several NationsMart directors and officers in January, 1994 that: 1) the sales forecasts in the Prospectus were baseless, 2) Defendant Thaman had been concealing loans to friends, 3) the Company's books had been altered, 4) the Company was violating the Fair Labor Standards Act, and 5) "certain affiliated party dealings were unfair to NationsMart." (Compl., ¶53). According to Ms. Brueggemann, NationsMart's directors refused to revise the registration statement to "reflect known negative facts and adverse developments." (*Id.*). Ms. Brueggemann relayed her complaints formally to Defendant Kling on January 24, 1994. "Thus," Plaintiffs allege, "defendants had actual notice, on or before January 24, 1994, from the Company's Chief Financial Officer, that statements contained in the Offering Materials, namely, that the proceeds of the Offering would fund, *inter alia,* the opening of 108 new stores and the operation of the existing 51 stores by November 1994, were false, materially misleading and had no reasonable basis in fact." (*Id.*, ¶54).

Defendants argue that mere temporal proximity between optimistic projections and pessimistic disclosures does not warrant an inference of fraud, and that "'fraud by hindsight' is not actionable." *See Arazie*, 2 F.3d at 1467-68, quoting *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (7th Cir.), *cert. denied*, 498 U.S. 941 (1990). *Accord In re Healthcare Compare Corp. Securities Litigation*, 75 F.3d 276, 283 (7th Cir. 1996); *In re Glenfed, Inc. Securities Litigation*, 42 F.3d 1541, 1548-49 & n.8

(9th Cir. 1994); *Serabian v. Amoskeag Bank Shares, Inc.*, 24 F.3d 357, 367 (lst Cir. 1994); *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1129 (2d Cir. 1994); *Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1278 (D.C. Cir. 1994); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1042 (6th Cir. 1991).

Plaintiffs contend that the "fraud by hindsight" cases apply only when a company is unexpectedly confronted by problems external to its operations, not when the problems "are of a sort that it is not unreasonable to believe were ongoing and thus likely known to defendants before they were acknowledged." *Robbins*, 788 F.Supp. at 192. *See also Nicholas v. Poughkeepsie Savings Bank/FSB*, 1990 WL 145154 (S.D. N.Y. Sept. 27, 1990) (since disclosed information pertained to bank's own financial condition and business practices, rather than to external factors, one could reasonably infer that bank knew its previous projections lacked a reasonable basis).

The Ninth Circuit has recognized a gray area "[b]etween these two extremes—cases. . . in which falseness is clear from the facts that had existed all along and were later revealed, and cases in which, because of an intervening event, contemporaneous falseness cannot be explained merely by pointing to later inconsistent statements or conditions." *Glenfed*, 42 F.3d at 1549.

> There may situations in which what separates the allegedly fraudulent statement and the later, apparently inconsistent statement is an event internal to the company, such as the revaluation of assets, or the recalculation of loan loss reserves. In such a situation, explanation as to why the statements were false when made might be provided simply by pointing to the later statements—but without additional explanation the mere existence of the later statements might not be enough. . . . The fact that an allegedly fraudulent statement and a later statement are *different* does not

> necessarily amount to an explanation as to why the earlier statement was false. . . . In order to allege the circumstances constituting fraud, plaintiff must set forth facts explaining why the difference between the earlier and the later statements is not merely the difference between two permissible judgments, but rather the result of a falsehood.

Id.

One would expect several of Ms. Brueggemann's allegations to have been known to NationsMart prior to her disclosure. Defendant Thaman, of course, would have known that he was concealing loans to friends; and some directors or officers probably would have known that the Company's books had been altered, that it was violating the FLSA, and that some affiliated party transactions were unfair. Plaintiffs' claims, however, revolve around Ms. Brueggemann's first allegation: that the sales forecasts in the Prospectus were baseless. This allegation falls within the gray area discussed in *Glenfed.* Plaintiff fails to allege specific facts explaining why the discrepancy between the Company's forecasts and Ms. Brueggemann's forecasts was fraudulent. 42 F.3d at 1549. The Court finds that the mere proximity between the offering and Ms. Brueggemann's subsequent disclosures does not support Plaintiffs' allegation that the forward-looking statements in the Prospectus lacked a reasonable basis.

Plaintiffs allege that Defendants failed to perform their duty to "correct and update their statements as soon as they knew or should have known that the statements were materially false and misleading." (Compl., ¶65). Defendants may have had a duty to update and correct some of their projections, as discussed below. *See Ackerman v. Schwartz*, 947 F.2d 841, 848 (7th Cir. 1991) ("Offering materials must be correct and non-misleading at the time of the sale, and not just as of the time they were written.");

Backman v. Polaroid Corp., 910 F.2d 10, 17 (lst Cir. 1990) (a forward-looking statement occasionally may need to be corrected if it has become misleading); *Isquith v. Middle South Utilities, Inc.*, 847 F.2d 186, 205 n.13 (5th Cir.) ("[T]here is a duty to correct statements made in any filing. . . if the statements either have become inaccurate by virtue of subsequent events, or are later discovered to have been false and misleading from the outset, and the issuer knows or should know that persons are continuing to rely on all or any material portion of the statements."), *cert. denied*, 488 U.S. 926 (1988); *S.E.C. v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1098-99 (2d Cir. 1972) (corporation has duty to amend a prospectus if statements contained therein become misleading "because of material post-effective events"). However, since liability under § 11 requires misrepresentations or omissions in "any part of the registration statement, *when such part became effective*," there can be no duty to update a registration statement. 15 U.S.C. § 77k(a) (emphasis added). *See also Manor Nursing Centers*, 458 F.2d at 1099 & n.24 (assumes issuer was not required to amend registration statement). The Court concludes that most of the statements challenged in Count I of Plaintiffs' Consolidated Amended Class Action Complaint fall within the "safe harbor" for "forward-looking statements," 17 C.F.R. §230.175, and therefore are not fraudulent as a matter of law.

Moreover, the Court finds that the forward-looking statements challenged by Plaintiffs "bespeak caution," because they are accompanied by sufficient cautionary language as to render them not materially misleading as a matter of law. *See In re Worlds of Wonder Securities Litigation*, 35 F.3d 1407, 1413-14 (9th Cir. 1994), *cert. denied*, 116 S.Ct. 185 (1995); *In re Donald J. Trump Casino Securities Litigation*, 7 F.3d 357, 371 (3d Cir. 1993), *cert. denied*, 114 S.Ct. 1219 (1994); *Moorhead v. Merrill Lynch*, 949 F.2d 243, 245 (8th Cir. 1991); *I. Meyer Pincus & Assoc. v. Oppenheimer & Co., Inc.*, 936 F.2d 759, 763 (2d Cir.

1991); *Luce v. Edelstein*, 802 F.2d 49, 56 (2d Cir. 1986); *Polin v. Conductron Corp.*, 552 F.2d 797, 806 n.28 (8th Cir.), *cert. denied*, 434 U.S. 857 (1977). *See also Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1097 (1991) ("While a misleading statement will not always lose its deceptive edge simply by joinder with others that are true, the true statements may discredit the other one so obviously that the risk of real deception drops to nil.").

"Although materiality is a mixed question of law and fact which the trier of fact ordinarily decides, . . . 'if the alleged misrepresentations or omissions are so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality [it is] appropriate for the district court to rule that the allegations are inactionable as a matter of law.'" *Trump*, 7 F.3d at 369 n.13, quoting *Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 280 & n.11 (3d Cir.), *cert. denied*, 506 U.S. 934 (1992) (other citations omitted). *Accord Goldman v. Belden*, 754 F.2d 1059, 1067 (2d Cir. 1985).

The "bespeak caution doctrine" applies only if the cautionary statements are "substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge." *Trump*, 7 F.3d at 371-72. Blanket warnings are insufficient. *Worlds of Wonder*, 35 F.3d at 1414-15.

Plaintiffs contend that the Prospectus in this case contains only generalized warnings, not tailored to the forward-looking statements which they challenge. The Court disagrees. Plaintiffs' central claim is that Defendants falsely represented that NationsMart would open 108 Centers by November, 1994 and 600 Centers by 1998, and that the proceeds of the offering would be sufficient to cover Center opening and operating costs and redemption of certain subordinated notes. The risk disclosures contained in the Prospectus are precisely tailored to these representations. After noting generally that the NationsMart securi-

ties are speculative and involve a high degree of risk, the Prospectus reports that the Company's accountants had a "substantial doubt" as to its "ability to continue as a going concern." (Prospectus, at 6). Although the Company indicates that the offering would alleviate some of this concern, it also warns that actual results would depend on many factors outside its control. (*Id.* at 19). The Prospectus discloses the Company's history of net losses, negative cash flow, and accumulated deficits, and notes that these trends are likely to continue in the future. (*Id.* at 6). The Company warns investors that it has a limited history and is vulnerable to business risks associated with rapidly growing firms, including the ability to attract and retain qualified employees, integrate new Centers into ongoing operations, and obtain additional financing. (*Id.*). Finally, NationsMart concedes that its ability to attract external financing would depend on its ability to "achieve significant sales growth, profitability and positive cash flow from operations." (*Id.* at 6-7). The foregoing cautionary language is both substantive and closely tailored to Defendants' forward-looking statements. Contrary to Plaintiffs' bare assertion, the cautionary language is not overbalanced by false positive statements. (Pltfs' Mem. in Opp. to Defts' Mtns. to Dismiss, at 16).

Plaintiffs argue that the bespeak caution doctrine is inapplicable where, "as here, the predictions themselves are alleged to be misleading." (*Id.* at 17). The cases cited by Plaintiffs do not support their position. In *Goldman*, 754 F.2d at 1068-69, and *Robbins,* 788 F.Supp. at 184-86, the courts actually found that the defendants' cautionary language was too general to render the predictions immaterial as a matter of law. The remaining courts distinguished between predictions on the one hand and misrepresentations of current fact or misleading opinions on the other hand, and held that the bespeak caution doctrine applies to the former but not the latter. *Mayer v. Mylod,* 988 F.2d 635,

638-39 (6th Cir. 1993); *In re Integrated Resources Real Estate Limited Partnerships Securities Litigation,* 815 F.Supp. 620, 674 (S.D. N.Y. 1993); *Griffin v. NcNiff,* 744 F.Supp. 1237, 1253-54 (S.D. N.Y. 1990), *aff'd,* 996 F.2d 303 (2d Cir. 1993), and *Friedman v. Arizona World Nurseries Ltd.*, 730 F.Supp. 521, 541 (S.D. N.Y. 1990), *aff'd,* 927 F.2d 594 (2d Cir. 1991).

Most of the statements challenged by Plaintiffs in the instant case qualify as predictions rather than statements of current fact or opinions, at least as of December, 1993 when the Registration Statement became effective. To the extent that Plaintiffs allege that those predictions *became* statements of current fact or opinion with the passage of time, perhaps requiring correction, such allegations are irrelevant to Count I, because there is no duty to update a registration statement. *See* 15 U.S.C. § 77k(a); *Manor Nursing Centers*, 458 F.2d at 1099 & n.24.

Accordingly, the Court finds that most of the representations challenged by Plaintiffs in Count I are "forward-looking statements" within the meaning of 17 C.F.R. § 230.175, and that those statements are accompanied by cautionary language bespeaking caution as a matter of law.

Statements of Historical or Current Fact

Although most of the allegedly fraudulent statements challenged in Count I are forward-looking statements, Plaintiffs do allege that the Registration Statement contains some false statements of "historical and current fact." (Pltfs' Mem. in Opp. to Defts' Mtns. to Dismiss, at 19, 22). Plaintiffs specifically direct the Court's attention to paragraphs ¶¶2, 23-31, 33-35, 37, and 40-42 of their Consolidated Amended Class Action Complaint. (*Id.* at 22). The Court finds that paragraphs 23 through 29, 34, and 35 simply quote or describe portions of the Prospectus without asserting that any of such portions are false. Paragraphs 30 and 31 pertain to forward-looking statements, which the Court

already has addressed.

Only paragraphs 2, 33, 37, 41 and 42 even arguably allege false statements of current or historical fact for purposes of Count I. These five paragraphs and their subparts fail to comply with Rule 9(b), which requires a plaintiff to state with particularity "the time, place, and contents of false representations, as well as the identity of the person making the misrepresentation. . . ." *Bennett*, 685 F.2d at 1062. The plaintiff also must "'set forth what is false or misleading about [the] statement, and why it is false.'" *Fecht v. Price Co.*, 70 F.3d 1078, 1082 (9th Cir. 1995), quoting *Glenfed*, 42 F.3d at 1548. *Accord Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993). Finally, the plaintiff must state facts showing that the false representation is material. *Shushany v. Allwaste, Inc.*, 992 F.2d 517, 522 & n.9 (5th Cir. 1993). *See also Decker v. Massey-Ferguson*, 681 F.2d 111, 116 (2d Cir. 1982) (allegations insufficient under Rule 9(b) where plaintiffs failed to even estimate the discrepancy between actual and reported book value of certain assets).

Paragraph 2 alleges as follows:

> By the time the long-delayed NationsMart Offering closed on December 22, 1993, defendants knew that cost and revenue trends had moved consistently and materially in the wrong directions. Rather than cancel the Offering, the defendants concealed the adverse developments, which severely compromised the viability of NationsMart's purported business plan. In addition, the defendants falsely stated that dealings with affiliates were at arms-length and that NationsMart was in compliance with federal wage and hour laws, and falsely omitted to state that the president of NationsMart was lending company money to his personal business associates for improper purposes. After the Offering, defendants made a series of misleading

> disclosures, which were designed to and did conceal NationsMart's problems from the market. NationsMart is now in serious financial difficulty, and the market value of its stock has dropped 82%.

(Compl., ¶2). This paragraph contains absolutely no detail supporting its sweeping allegations of fraud, probably because this paragraph is intended merely to summarize the Complaint. Plaintiffs cannot rely on paragraph 2 to state a claim.

Paragraph 33 alleges that Defendants falsely represented the average cost of opening a Center, but it neither provides a basis for this conclusion nor states the actual cost of opening a Center. (*Id.*, ¶33). Therefore paragraph 33 fails to comply with Rule 9(b). *Fecht,* 70 F.3d at 1082; *Mills*, 12 F.3d at 1175; *Shushany*, 992 F.2d at 522 & n.9.

Paragraph 37 fares no better. Here Plaintiffs allege that the Prospectus "create[d] the false impression that defendants, in making the foregoing representations, had considered all relevant financial risks and that defendants' projections were reasonable and made in good faith upon fair consideration of all relevant negative factors." (Compl., ¶37). The Court cannot ascertain which of the "foregoing representations" Plaintiffs have in mind. Plaintiffs further fail to provide any basis for their conclusion that Defendants' projections were not reasonable and not made in good faith. *Fecht,* 70 F.3d at 1082; *Mills*, 12 F.3d at 1175.

Plaintiffs likewise fail to provide the Court with any basis for their conclusory assertions in paragraph 41:

> [D]uring the months immediately before the Effective Date, defendants knew of and learned a variety of adverse facts concerning NationsMart's performance, including that there were no favorable revenue, profit and expense trends as described in the Prospectus; that

> projected trends were not materializing and were not likely to materialize; that NationsMart had no site selection strategy, other than to open a Center willy-nilly wherever and whenever a new Wal-Mart Supercenter or Super Kmart opened, regardless of local competition or demographic suitability; and that the Company was routinely breaking the law and entering into "sweetheart" deals with affiliates of NationsMart's officers and directors.

(Compl., ¶41). Plaintiffs do not specify which "revenue, profit and expense trends" are described inaccurately in the Prospectus, nor do they document the source of their conclusions that "projected trends were not materializing" and that the Company was breaking the law and entering into "sweetheart deals" with affiliates. Plaintiffs also do not demonstrate that the allegedly negative performance trends or affiliated party dealings were material.

Paragraph 42 comes closest to stating a claim:

> In the months immediately prior to the Offering, many, if not most, significant indicators of NationsMart's performance and future success were on a steep downward slope, including but not limited to the following:
>
> > (a) the amount of time which defendants believed a store had to operate before becoming profitable had continually increased significantly, i.e., the expected "break-even" date for a store had been extended and was becoming even more distant;
> >
> > (b) the amount of money needed to open and subsidize a Center until it became profitable had increased substantially and was continuing to increase;

(c) the cost to operate existing Centers had increased substantially;

(d) corporate overhead was ballooning, and despite the Prospectus' statements to the effect that as of the end of September, 1993, the Company had substantially completed the "infrastructure" needed to carry the Company forward without substantial additional expenditures in this regard, NationsMart spent almost as much in the last three months of 1993 as it had in all of the preceding nine months;

(e) While the Prospectus states that the defendants expected corporate overhead as a percentage of net sales to decline, they knew by the Effective Date that the percentage of corporate overhead to net sales had not declined appreciably. Indeed, except for a brief section of the first quarter of 1994, corporate overhead as a percentage of net sales had increased, from 76% (as disclosed in the Prospectus) to 83% (as disclosed in the Company's 10-Q for the second quarter of 1994, page 2); and

(f) the Company's "burn rate," or the rate at which it used up its capital, had skyrocketed. The Prospectus disclosed that the Company would be out of money in January, 1994, absent the Offering. It did not disclose the exponential increase in expenses and costs which had put it in that position. Nor did it disclose the lack of any realistic prospect that the situation would improve after the Offering.

(Compl., ¶42). Nonetheless, these allegations fall short of Rule 9(b). Plaintiffs make no attempt to quantify the negative trends

identified in subparagraphs (a), (b), and (c), and therefore they fail to demonstrate materiality. *Shushany*, 992 F.2d at 522 & n.9; *Decker*, 681 F.2d at 116. Subparagraph (e) does contain some statistical figures, but they post-date the offering, and therefore could not possibly indicate fraud as of the effective date. Plaintiffs fail to explain the basis for their conclusions in subparagraphs (d) and (e) that Defendants fraudulently understated their overhead costs. Finally, Plaintiffs have not convinced the Court that Defendants were required to explain the reasons for their lack of capital resources, which Plaintiffs concede in subparagraph (e) was fully disclosed.

Plaintiffs have failed to allege with sufficient particularity that the Registration Statement, as of December 22, 1993, contained any "untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). Accordingly, Count I will be dismissed as to all Defendants for failure to state a claim and failure to allege fraud with particularity. Fed. R. Civ. P. 12(b)(6), (9)(b). The Court need not reach the other issues raised in Defendants' motions as they pertain to Count I.

Count III - §§ 10 and 20 of the Securities Exchange Act And Rule 10b-5

Section 10(b) of the Securities Exchange Act of 1934 provides in pertinent part,

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a

> national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). The SEC in turn issued Rule 10b-5, which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. Section 20 of the Securities Exchange Act extends liability under § 10(b) and Rule 10b-5 to any controlling person. 15 U.S.C. § 78t(a).

To prevail on a Rule 10b-5 claim, a plaintiff must demonstrate 1) that the defendant "acted in a manner prohibited by the Rule," 2) "causation, often analyzed in terms of materiality and reliance; 3) damages; and 4) that the fraudulent activity occurred in

connection with the purchase and sale of a security." *Harris v. Union Electric Co.*, 787 F.2d 355, 362 (8th Cir. 1982), *cert. denied*, 479 U.S. 823 (1986). "A finding of scienter, that is, an 'intent to deceive, manipulate, or defraud,' is also a prerequisite to recovery under section 10(b) and Rule 10b-5." *Id.*, quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). *Accord Ligon v. Deloitte, Haskins & Sells*, 957 F.2d 546, 547 (8th Cir. 1992).

Chapter 17 of the Code of Federal Regulations creates a safe harbor immunizing forward-looking statements from liability under § 10(b) and Rule 10b-5. 17 C.F.R. § 240.3b-6. This regulation is identical to 17 C.F.R. § 230.175, discussed earlier in conjunction with liability under § 11 of the Securities Act, 15 U.S.C. §77k(a). Based on its previous analysis of § 230.175, the Court concludes that most of the statements contained in NationsMart's Prospectus and Registration Statement were not fraudulent as of December 22, 1993, because they were forward-looking and they bespoke caution. The few remaining statements challenged by Plaintiffs fail as well, because they do not comply with Rule 9(b).

As the Court noted earlier, however, Defendants may have had a duty to update and correct projections in the Prospectus to the extent they became materially misleading over time. *See Ackerman*, 947 F.2d at 848 ("Offering materials must be correct and nonmisleading at the time of the sale, and not just as of the time they were written."); *Backman*, 910 F.2d at 17 (a forward-looking statement occasionally may need to be corrected if it has become misleading); *Isquith*, 847 F.2d at 205 n.13 ("[T]here is a duty to correct statements made in any filing. . . if the statements either have become inaccurate by virtue of subsequent events, or are later discovered to have been false and misleading from the outset, and the issuer knows or should know that persons are continuing to rely on all or any material portion of the statements."); *Manor Nursing Centers*, 458 F.2d at 1098-99

(corporation has duty to amend a prospectus if statements contained therein become misleading "because of material post-effective events").

Moreover, Plaintiffs allege that various NationsMart directors made a series of false and misleading statements following the effective date of the offering. The Court's resolution of Count I therefore does not dictate dismissal of Count III.

Defendants seek dismissal of the "post-offering allegations" in Count III for failure to adequately plead reliance.[4] Reliance is an essential element of a claim under Rule 10b-5. *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988). "Ordinarily, reliance requires proof that the misrepresentations actually induced plaintiffs to act differently than they otherwise would have in making their investment decisions." *Austin v. Loftsgaarden*, 675 F.2d 168, 177 (8th Cir. 1982), citing *St. Louis University Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1048 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978).

Courts presume reliance in at least two situations. First, "in cases involving primarily a failure to disclose, reliance will be presumed upon a showing that the withheld information was material." *Austin*, 675 F.2d at 177, citing *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). Most Courts of Appeals to consider the question, including the Eighth Circuit, have limited the "*Affiliated Ute*" presumption to face to face transactions where there was a duty of disclosure. *Laventhall v. General Dynamics Corp.*, 704 F.2d 407, 413 n.4 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983); *Rowe v. Maremont Corp.*, 850 F.2d

[4] Defendants do not request dismissal on this ground of statements made in the offering materials, because they believe that these statements fall within the safe harbor for forward-looking statements which bespeak caution. The Court has found that the safe harbor for forward-looking statements applied as of December 22, 1993. However, the very same statements did not fall within the safe harbor to the extent they became false or misleading over time and to the extent Defendants continued to disseminate them.

1226, 1233 n.4 (7th Cir. 1988); *Levinson v. Basic Inc.*, 786 F.2d 741, 750 (6th Cir. 1986), *vac. on other grounds,* 485 U.S. 224 (1988). *But see Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 240 (2d Cir. 1974) (refusing to limit *Affiliated Ute* to face to face transactions).

Second, courts presume reliance where "materially misleading statements have been disseminated into an impersonal, well-developed market for securities." *Basic*, 485 U.S. at 247, 250. "Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." *Id.* at 247. The following factors may tend to show that a "security was traded in an efficient market, justifying the application of the fraud on the market theory: (1) a large weekly trading volume; (2) the existence of a significant number of reports by securities analysts; (3) the existence of market makers and arbitrageurs in the security; (4) the eligibility of the company to file an S-3 Registration Statement; and (5) a history of immediate movement of the stock price caused by unexpected corporate events or financial releases." *Freeman v. Laventhol & Horwath*, 915 F.2d 193, 199 (6th Cir. 1990), citing *Cammer v. Bloom*, 711 F.Supp. 1264, 1286-87 (D. N.J. 1989), *app. dism'd,* 993 F.2d 875 (3d Cir. 1993).

The fraud on the market theory is rarely available in the context of initial public offerings, because "'an inefficient market, by definition, does not incorporate into its price all the available information about the value of a security.'" *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1158-59 (6th Cir. 1994), quoting *Freeman*, 915 F.2d at 198. *Accord Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1130 (7th Cir. 1993), *cert. denied*, 114 S.Ct. 883 (1994); *Alter v. DBLKM, Inc.*, 840 F.Supp. 799, 804-05 (D. Colo. 1993); *Gruber v. Price Waterhouse*, 776 F.Supp. 1044, 1052 (E.D. Pa. 1991). One court has applied the theory to newly issued securities, however, where the plaintiffs

rebutted the defendants' motion for summary judgment with evidence of:

> 1) the issuance of a substantial volume of securities; 2) a large number of investors; 3) the direct involvement of many underwriters in the offering; and 4) the existence of an impersonal, national trading market where the price of a stock is much more likely to reflect the public availability of information.

Endo v. Albertine, 863 F.Supp. 708, 726 (N.D. Ill. 1994) (internal footnotes omitted).

A few courts have recognized a "fraud created the market" theory in the context of initial public offerings. *Ross v. Bank South, N.A.*, 885 F.2d 723, 729 (llth Cir. 1989), *cert. denied*, 495 U.S. 905 (1990); *T.J. Raney & Sons v. Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330, 1333 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026 (1984); *Shores v. Sklar*, 647 F.2d 462, 469-70 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983). *But see Eckstein*, 8 F.3d at 1130 (rejecting theory); *Ockerman*, 27 F.3d at 1160 (questioning theory). According to the fraud created the market theory, reliance may be presumed only if the fraud is "so pervasive that it goes to the very existence of the [securities] and the validity of their presence on the market." *Ross*, 885 F.2d at 729.

Rule 9(b) requires that reliance be pleaded with particularity. *See In re Sahlen & Associates, Inc. Securities Litigation*, 773 F.Supp. 342, 352-53 (S.D. Fla. 1991) (dismissing 10(b) complaints which failed to allege "which particular documents were read or reasonably relied upon by which [p]laintiffs"). *See also Arena Land & Investment Co., Inc. v. Petty*, 906 F.Supp. 1470, 1479 (D. Utah 1994) ("plaintiffs have not pled the element of reliance with sufficient particularity"), *aff'd*, 69 F.3d 547 (10th Cir. 1995).

Plaintiffs' Consolidated Amended Class Action Complaint contains the following sparse allegations regarding reliance:

> Plaintiffs and other members of the Class, at the time of the alleged misrepresentations and omissions, were ignorant of the falsity of the statements, and believed them to be true. In reliance upon the defendants' misrepresentations, the integrity of the market and the securities offering process, and upon the fidelity, integrity and superior knowledge of the defendants, and in ignorance of the truth, plaintiffs and the other Class members were induced to and did obtain NationsMart securities. Had plaintiffs and the other members of the Class known the truth, they would not have taken such action.

(Compl., ¶88). The stipulated Class Certification Order does not even mention reliance:

> The claims asserted in Count III of the Complaint are certified as a class action. . . on behalf of a class ("Class B") consisting of all persons who purchased NationsMart securities in the Offering (as defined in the Complaint) or in the open market and who suffered damages as a result thereof. (November 22, 1995 Order Certifying Classes, ¶2).

Defendants argue that Plaintiffs' 10b-5 claim fails as to post-offering statements, because Plaintiffs fail to specify the dates of their stock purchases. If Plaintiffs purchased their shares *before* the post-offering statements, Defendants argue, they cannot rely on the post-offering statements to establish fraud. *Haft v. Eastland Financial Corp.*, 772 F.Supp. 1315, 1318, 1321 (D. R.I. 1991).

According to Plaintiffs, "[t]his argument must be rejected because it is merely a challenge to the duration of the Class

Period and plaintiffs' ability to represent a class that includes some members whose purchases post-date their own." (Pltfs' Mem. in Opp. to Defts' Mtns. to Dismiss, at 28). This is especially true in the present case, Plaintiffs argue, because Defendants allegedly engaged in a "unitary scheme and conspiracy spanning a number of months" and because the named Plaintiffs purchased early in the class period. (*Id.* at 29).

Plaintiffs' argument is seriously weakened by the Court's determination that the offering materials were not materially false or misleading as of December 22, 1993. Those materials may have become false or misleading over time, and hence actionable, insofar as Defendants continued to disseminate the Prospectus. Moreover, Defendants allegedly made numerous false or misleading statements after the effective date of the offering. The Court cannot assume, however, that Plaintiffs purchased their shares *after* Defendants made false or misleading statements.

In any event, the Court finds that Plaintiffs have failed to allege reliance with the particularity required by Rule 9(b). Like the plaintiffs in *Sahlen & Associates*, 773 F.Supp. at 352-53, Plaintiffs here have failed to allege which false statements or misrepresentations were relied upon by which Plaintiffs. Unless Plaintiffs can invoke a presumption of reliance, their class-based allegations of reliance must fail. *See Basic*, 485 U.S. at 242 ("the presumption of reliance created by the fraud-on-the-market theory provided 'a practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of [Federal Rule of Civil Procedure] 23.'") (quoting district court opinion).

Plaintiffs' allegations do not give rise to a presumption of reliance under any of the foregoing theories. They do not allege any face to face transactions between themselves and Defendants, giving rise to a duty to disclose. *Affiliated Ute*, 406 U.S.

at 153-54; *Laventhall*, 704 F.2d at 413 n.4. Neither do Plaintiffs allege particular facts showing that the NationsMart securities were traded on an "impersonal, well-developed market for securities," which would justify application of the fraud on the market theory. *Basic*, 485 U.S. at 247, 250. Finally, Plaintiffs do not allege facts showing that but for Defendants' fraud, there would have been no market for NationsMart's securities. Therefore they are not entitled to the presumption of reliance created by the fraud created the market theory. *Ross*, 885 F.2d at 729.

The Court therefore dismisses Count III as to all Defendants for failure to allege reliance with particularity. Fed. R. Civ. P. 9(b). The Court need not address the other issues raised in Defendants' motions as they pertain to Count III.

Count II - § 12(2) of the Securities Act

Section 12(2) of the Securities Act of 1933 provides in relevant part,

> Any person who—
>
> * * *
>
> > (2) offers or sells a security. . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

> shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 77*l*(2). Reliance is not an element of a § 12(2) claim. *Austin*, 675 F.2d at 176 n.16.

The safe harbor for forward-looking statements discussed in conjunction with Plaintiffs' claims under § 11 of the Securities Act also applies to claims under § 12(2) of the Securities Act. 17 C.F.R. § 230.175. Therefore the Court finds that most of the statements contained in NationsMart's Prospectus were not fraudulent as of December 22, 1993, because they were forward-looking and they bespoke caution. The few remaining statements challenged by Plaintiffs fail as well, because they do not comply with Rule 9(b).

The lead underwriters move to dismiss Count II against them to the extent that it seeks to recover for any "non-projection (or forward-looking) allegations made after the effective date of the offering. [docket #37]. The only reference in the Complaint to conduct by the underwriters after the effective date is the following:

> On March 31, 1994, Robert Darrington of defendant Pauli touted NationsMart's competitive superiority. An analyst from defendant RAS stated that NationsMart should show a profit within 15 months.

(Compl., ¶46). The Court agrees that this one paragraph fails to plead with particularity the circumstances of these allegedly fraudulent statements. Fed. R. Civ. P. 9(b). Were these statements the only basis for the underwriters' liability, the Court would grant their motion.

As the Court previously noted, though, all of the Defendants may have had a duty to update and correct projections in the Prospectus to the extent they became materially misleading over time. The First, Fifth, and Seventh Circuits have stated that the failure to correct a materially misleading prospectus may give rise to liability under § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j (b), and Rule 10b-5, 17 C.F.R. § 240.10-b. *See Ackerman*, 947 F.2d at 848 ("Offering materials must be correct and non-misleading at the time of the sale, and not just as of the time they were written."); *Backman*, 910 F.2d at 17 (a forward-looking statement occasionally may need to be corrected if it has become misleading); *Isquith*, 847 F.2d at 205 n.13 ("[T]here is a duty to correct statements made in any filing . . . if the statements either have become inaccurate by virtue of subsequent events, or are later discovered to have been false and misleading from the outset, and the issuer knows or should know that persons are continuing to rely on all or any material portion of the statements."). The Second Circuit has found that the failure to correct a misleading prospectus gives rise to liability under §§ 5(b)(2) and 10(a) of the Securities Act of 1933, 15 U.S.C. §§ 77e(b)(2), 77j(a), which require in conjunction with a sale of securities the delivery of a prospectus meeting certain specifications. *Manor Nursing Centers*, 458 F.2d at 1098-99 (corporation has duty to amend a prospectus if statements contained therein become misleading "because of material post-effective events"). *Accord Nelson v. Paramount Communications, Inc.*, 872 F.Supp. 1242, 1247 (S.D. N.Y. 1994).

One court has refused to recognize a duty to update a prospectus for purposes of liability under §§ 11 or 12(2) of the Securities Act, 15 U.S.C. §§ 77k(a), 77*l*(2). *In re Bank of Boston Corporation Securities Litigation*, 762 F.Supp. 1525, 1537 (D. Mass. 1991). The Third Circuit noted the possibility of such a duty but found it unnecessary to reach the issue. *Craftmatic Securities Litigation v. Kraftsow*, 890 F.2d 628, 645 (3d Cir. 1989) (plain-

tiffs do not allege in their § 12(2) claim that defendants had a duty to amend prospectus).

Because the parties have not briefed this issue, the Court declines to decide the issue at this time. Because Natior.sMart and the underwriters may have had a duty to update the Prospectus, however, the Court will not dismiss the allegations concerning statements in the Prospectus insofar as those statements became false or misleading after December 22, 1993.

NationsMart requests dismissal of the § 12(2) claim on the grounds that Plaintiffs fail to allege that they purchased their shares in a public offering rather than in the secondary market. The Court is not certain that the Supreme Court's recent decision in *Gustafson* answers this question. *Gustafson v. Alloyd Co., Inc.*, 115 S.Ct. 1061 (1995) (private sale agreement does not qualify as a "prospectus" for purposes of § 12(2) liability).

The Courts of Appeals that have addressed the issue are split. *Compare First Union Discount Brokerage Services v. Milos,* 997 F.2d 835, 843-44 (llth Cir. 1993) (§ 12(2) does not apply to trading in the aftermarket), and *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 693 (3d Cir. 1991) (same), *cert. denied*, 502 U.S. 820 (1991), *with Pacific Dunlop Holdings Inc. v. Allen & Company Inn.*, 993 F 2d 578, 582 (7th Cir. 1993) (§ 12(2) does apply to secondary market transactions), *cert. dism'd,* 114 S.Ct. 1146 (1994).

Several courts have permitted purchasers in the secondary market to assert a § 12(2) claim, as long as their shares are traceable to a public offering. *See Stack v. Lobs,* 903 F.Supp. 1361, 1375 (N.D. Cal. 1995); *McMahan & Co. v. Wherehouse Entertainment, Inc.*, 859 F.Supp. 743, 755 (S.D. N.Y. 1994), *aff'd in part, rev'd in part on other grounds*, 65 F.3d 1044 (2d Cir. 1995); *In re AES Corp. Securities Litigation*, 825 F.Supp. 578, 593 (S.D. N.Y. 1993). The *McMahan* court explained,

> To establish liability under § 12(2), a plaintiff must have purchased securities pursuant to a false or misleading prospectus. . . .While this purchase is often during the initial offering, claims "may be brought by persons who purchased shares 'traceable' to the public offering."

859 F.Supp. at 755 (internal citations omitted).

This Court need not decide whether § 12(2) applies to secondary market transactions having no nexus with an initial public offering, because the Consolidated Amended Class Action Complaint alleges that "The securities purchased by each plaintiff are traceable to the Offering." (Compl., ¶7(e)). This allegation is sufficient to withstand dismissal.

NationsMart also seeks dismissal of the § 12(2) claim against it because it is not a "seller" within the meaning of the statute. The Supreme Court held in *Pinter v. Dahl*, 486 U.S. 622, 647 (1988), that the term "seller" as used in § 12(1) includes not only a person who passes title to securities, but one "who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." The Third Circuit extended this reasoning to § 12(2), and explained,

> [A]lthough an issuer is no longer immune from § 12 liability, neither is an issuer liable solely on the basis of its involvement in preparing the prospectus. The purchaser must demonstrate direct and active participation in the solicitation of the immediate sale to hold the issuer liable as a § 12(2) seller.

Craftmatic Securities Litigation v. Kraftsow, 890 F.2d 628, 636 (3d Cir. 1989). "The focus of the inquiry is on the alleged solicitor's relationship to the purchaser, not the degree of his involvement in the sales transaction and its surrounding circum-

stances." *Wiley v. Hughes Capital Corp.*, 746 F.Supp. 1264, 1280 (D. N.J. 1990), citing *Craftmatic*, 890 F.2d at 636. Solicitation must be alleged with particularity under Rule 9(b). *Friedman v. Arizona World Nurseries Ltd.*, 730 F.Supp. 521, 542 (S.D. N.Y. 1990), *aff'd*, 927 E.2d 594 (2d Cir. 1991).

Plaintiffs simply allege that "NationsMart and the Underwriter Defendants offered, sold, and solicited sales of shares, by means of the Prospectus which included untrue statements and omissions of material fact." (Compl., ¶76). The Prospectus itself belies the allegation that NationsMart "offered" or "sold" the securities, because it announces that the "several Underwriters" would offer the securities. (Prospectus, at 1). *See In re Newbridge Networks Securities Litigation*, 767 F. Supp. 275 , 280 (D. D. C. 1991) (plaintiffs could not have alleged that issuer was "seller," where securities concededly were sold through underwriters). Plaintiffs' bare allegation that NationsMart "solicited sales of shares" is insufficient to withstand dismissal. Plaintiffs fail to plead any facts showing NationsMart's "direct and active" participation in the sales. *Craftmatic*, 890 F.2d at 636. *See also VT Investors v. R & D Funding Corp.*, 733 F.Supp. 823, 839-40 (D. N.J. 1990) (dismissing § 12(2) claim where plaintiffs failed to allege any specific facts demonstrating active solicitation by defendants in sales of securities). Completely absent from Plaintiffs' Complaint is any allegation that in soliciting its securities, NationsMart was "motivated at least in part by a desire to serve [its] own financial interests. . . ." *Pinter*, 486 U.S. at 647. *See also VT Investors*, 733 F.Supp. at 840 ("Plaintiffs' failure to allege any personal or direct financial benefit to the seller is fatal to their purported § 12(2) claim."). Accordingly, the Court will dismiss Count II as to NationsMart

The underwriter Defendants qualify as "sellers" for purposes of § 12(2), and they do not argue otherwise. Because the Court has found that Defendants (including the underwriters) may

have had a duty to update or correct the Prospectus to the extent it became false or misleading after the effective date of the offering, the § 12(2) claim against the lead underwriters, RAS and Pauli, will not be dismissed at this time.

The 25 additional underwriters originally named as Defendants in Cause No. 4:95CV1274 DDN, and consolidated with the instant action in July, 1995, request dismissal of all of Plaintiffs' claims against them on the grounds that they are time-barred. (Mtn. to Dismiss of Add'l Underwriters). Because the Court dismissed Counts I and III against all Defendants on other grounds, it need only consider the statute of limitations issue as to Count II.

Section 13 of the Securities Act of 1933 imposes a one year/three year statute of limitations on claims pursuant to § 12(2):

> No action shall be maintained to enforce any liability created under. . . section 12(2) unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence. . . . In no event shall any such action be brought to enforce a liability created under. . . section 12(2) more than three years after the sale.

15 U.S.C. § 77m. The Eighth Circuit has explained,

> The one-year limitations period "does not 'commence only when a plaintiff has full knowledge of the existence of a claim. On the contrary, [it] begins to run even when a plaintiff is placed on 'inquiry notice' of possible misrepresentations.'"

Davidson v. Wilson, 973 F.2d 1391, 1402 (8th Cir. 1992) (citations omitted).

Compliance with the limitations period "must be pled with

specificity," meaning that "'a plaintiff must affirmatively plead facts indicating the action has been timely brought.'" *Id.* at 1402 n.8, quoting *Hagert v. Glickman, Lurie, Eiger & Co.*, 520 F.Supp. 1028, 1033 (D. Minn. 1981). *Accord Southwest Investments I v. Midland Energy Co.*, 596 F.Supp. 219, 222 (E. D. Mo. 1984). A conclusory assertion that the plaintiff has complied with the statute of limitations is insufficient. *Hagert*, 520 F.Supp. at 1033. A complaint may be dismissed if the allegations reveal on their face that the plaintiffs failed to comply with the limitations period. *Tregenza v. Great American Communications Co.*, 12 F.3d 717, 719 (7th Cir. 1933), *cert. denied*, 114 S.Ct. 1837 (1994).

Plaintiffs filed the instant action against NationsMart, its directors, and the lead underwriters, on November 7, 1994. Plaintiffs filed a separate action against the 25 additional underwriters on July 11, 1995. (Cause No. 4:95CV1274 DDN). The Court consolidated the two cases on July 13, 1995.

Paragraph 72 of the Consolidated Amended Class Action Complaint is the only paragraph in the entire pleading addressing the timeliness issue, and that paragraph falls within Count I:

> This action was commenced within one year from when plaintiffs and other Class members purchased NationsMart shares pursuant to the Prospectus, and within the time provided in the appropriate statute of limitations.

(Compl., ¶72). Count II does not incorporate paragraph 72 by reference, nor does it contain any timeliness allegations of its own.

Even if the Court were to assume that paragraph 72 applies to Count II, however, that paragraph fails to "'affirmatively plead facts indicating the action has been timely brought.'" *Davidson*, 973 F.2d at 1402 n.8, quoting *Hagert*, 520 F.Supp. at 1033.

Moreover, paragraphs 51 and 53 of the Consolidated Amended Class Action Complaint affirmatively demonstrate that Plaintiffs' claims against the additional underwriters are untimely. Paragraph 51 states, "Contrary to numerous positive statements in the Company's Offering Materials and other subsequent public filings, on or about June 24, 1994, the investing public began to understand that NationsMart was hemorrhaging money and that the Company would be forced to implement a reorganization program." (Compl., ¶51). Paragraph 53 alleges that "[f]urther evidence of the Company's true financial condition and its prior misrepresentations to the investing public emerged on or about June 27, 1994, when defendant Brueggemann filed suit against the Company. . . ." (*Id.*, ¶53). According to Plaintiffs, Ms. Brueggemann's suit alleged that she told several NationsMart directors as early as January, 1994 that the sales forecasts contained in the Prospectus were "baseless and falsely optimistic," Defendant Thaman had been "'burying' loans to friends in false financial statements," the Company's books had been altered, the Company was violating the Fair Labor Standards Act, and "certain affiliated party dealings were unfair to NationsMart." (*Id.*).

The foregoing allegations demonstrate that Plaintiffs were on inquiry notice" of Defendants' alleged fraud no later than June 27, 1994. *Davidson*, 973 F.2d at 1402. The Court is not convinced by Plaintiffs' argument that they were not placed on notice of Defendants' fraud until October 2, 1994, when the Company filed its quarterly report noting that its losses were not inconsistent with management's initial expectations. (Pltfs' Mem. in Opp. to Add'l Underwriter Defts' Mtn. to Dismiss, at 8-9, citing ¶62 of Compl.). The Court draws further support for its conclusion from the fact that Plaintiffs filed their original lawsuit on November 7, 1994, eight months prior to their suit against the additional underwriters, all of whom were disclosed fully in the Prospectus. (Prospectus, at 40).

Because Plaintiffs did not file their § 12(2) claim against the 25 additional underwriter Defendants until July 11, 1995, over one year after they were placed on inquiry notice of Defendants' fraud, the Court will dismiss Count II against these Defendants as beyond the statute of limitations.

Counts I and III of the Consolidated Amended Class Action Complaint will be dismissed as to all Defendants. Count II will be dismissed as to Defendant NationsMart and the 25 additional underwriter Defendants. (Count II did not attempt to state a claim against the individual Defendants). Because Plaintiffs already have had three opportunities to amend, and the September 30, 1995 deadline for amendment of pleadings has long passed, these dismissals are with prejudice. The sole claim remaining in this action is the § 12(2) claim in Count II against the lead underwriter Defendants, RAS Securities Corporation and Pauli & Company, Inc.

THE MOTION OF NON-PARTY THE SOURCE COMPANY TO QUASH SUBPOENA

On June 5, 1995 Plaintiffs served a subpoena duces tecum on The Source Company, a non-party, ordering the production of various documents on June 21, 1995. The Source Company filed its Motion to Quash on July 5, 1995, objecting to the scope of some of the document requests contained in Schedule A to the subpoena. Plaintiffs have filed no response to the motion, and the Court cannot determine from the record whether the parties have resolved the matter.

After reviewing the motion and the document requests contained in Schedule A, the Court agrees with The Source Company that request nos. 1, 2, 4, 10, 11, and 12 are vague, overbroad, irrelevant, immaterial, and not calculated to lead to the discovery of admissible evidence. The Court also find that request no. 7 seeks documents which are irrelevant, immaterial, and not calculated to lead to the discovery of admissible evidence.

Finally, request no. 11 seeks production of at least some material that is protected by the attorney-client and work product privileges. The motion will be granted.

ACCORDINGLY,

IT IS HEREBY ORDERED that Defendants' Motion to Dismiss Claims Based on Projections of Future Performance [docket #39] is **GRANTED** in part and **DENIED** in part.

IT IS FURTHER ORDERED that the Motion to Dismiss of Defendants Pauli & Company, Incorporated and RAS Securities Corporation [docket #36] is **GRANTED** in part and **DENIED** in part.

IT IS FURTHER ORDERED that Defendants' Motion to Dismiss Claims Based on Allegations Other than Prospectus Allegations [docket #40] is **GRANTED** in part and **DENIED** in part.

IT IS FURTHER ORDERED that the lead Underwriters' Motion to Dismiss as to Non-Projection Allegations [docket #37] is **GRANTED** in part and **DENIED** in part.

IT IS FURTHER ORDERED that Defendant Alice E. Brueggemann's Motion to Dismiss [docket #35] is **GRANTED** in part and **DENIED** in part.

IT IS FURTHER ORDERED that the Motion to Dismiss of Additional Underwriter Defendants [docket #48] is **GRANTED** in part and **DENIED** in part.

IT IS FURTHER ORDERED that Counts I and III of the Consolidated Amended Class Action Complaint are **DISMISSED** with prejudice as to all Defendants.

IT IS FURTHER ORDERED that Count II of the Consolidated Amended Class Action Complaint is **DISMISSED** with

prejudice as to Defendant NationsMart and the 25 additional underwriter Defendants originally named in Cause No. 4:95CV1274 DDN.

IT IS FURTHER ORDERED that the sole claim remaining in this action is the § 12(2) claim in Count II against the lead underwriter Defendants, RAS Securities Corporation and Pauli & Company, Inc.

IT IS FURTHER ORDERED that the Motion of Non-Party The Source Company to Quash Subpoena [docket #31] is **GRANTED**.

Dated this 11th day of April, 1996.

/s/ Jean C. Hamilton

UNITED STATES DISTRICT JUDGE

APPENDIX C

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

Case No. 4:94CV2182 JCH

In re NationsMart Corporation
Securities Litigation

This Document Relates To:
All Actions

MEMORANDUM AND ORDER

This matter is before the Court on Plaintiffs' Motion Pursuant to Federal Rules of Civil Procedure 59(e) and 60(b) to Vacate the April 11, 1996 Memorandum and Order of the Court and Pursuant to Rules l 5(a) and 16(b) for Leave to Amend ("Motion to Vacate" or "Motion for Leave to Amend").

BACKGROUND

The long and complicated factual and procedural history of this lawsuit was laid out in great detail in this Court's Memorandum and Order of April 11, 1996, and therefore will not be recounted here. In such Memorandum and Order, the Court dismissed Counts I and III of the Consolidated Amended Class Action Complaint with prejudice as to all Defendants. The Court further dismissed Count II of the Consolidated Amended Class Action Complaint with prejudice as to Defendants NationsMart and the 25 additional underwriters, thereby leaving the 12(2) claim in Count II against the lead underwriter Defendants RAS

Securities Corporation and Pauli & Company, Inc. as the sole remaining claim in the action. (Court's Memorandum and Order of April 11, 1996, PP. 53-54)[1].

Plaintiffs filed their Motion to Vacate and for Leave to Amend on April 25, 1996. In such Motion, Plaintiffs asked the Court to amend its Memorandum and Order dismissing Plaintiffs' claims, or in the alternative, to extend the Scheduling Order deadline to grant Plaintiffs leave, pursuant to Federal Rules of Civil Procedure 15(a) and 16(b), to amend their Complaint.

Dismissed Defendants filed their Response to Plaintiffs' motion on May 17, 1996. Defendants RAS Securities Corporation and Pauli & Company, Inc. (hereinafter "Underwriter Defendants") filed a separate Response on that same date. Plaintiffs filed their Reply to both Responses on May 24, 1996.

On May 31, 1996, dismissed Defendants filed a Motion for Leave to Cite Additional Authority in Opposition to Plaintiffs' Motion to Vacate. Plaintiffs filed their Response to such motion on June 7, 1996. The Court hereby grants dismissed Defendants' Motion, and has considered such additional authority in making its ruling.

MOTION TO VACATE

1. *Timeliness of Plaintiffs' Rule 59(e) Motion*

Pursuant to Fed. R. Civ. P. 59(e), a motion to alter or amend judgment must "be served not later than **10 days** after entry of the judgment" (emphasis added). The ten-day limit, designed to protect the finality of judgments, is jurisdictional. Thus the Court

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[1]The Court's Order effectively dismissed the following Defendants from the suit: Michael E. Thaman, Alice E. Brueggemann, S. Leslie Flegel, Mel A. Friedman, Alan G. Johnson, Franklin A. Jacobs, S. Lee Kling, Michael J. Dunlap, and NationsMart (hereinafter "dismissed Defendants").

cannot alter, waive, or otherwise change the ten-day limitation. *McCarthy v. Manson*, 554 F.Supp. 1275, 1284 n. 9 (D.Conn. 1982), *aff'd.*, 714 F.2d 234 (2d Cir. 1983); *United States v. Hall*, 463 F.Supp. 787,791 n. 1 (W.D.Mo. 1978), *aff'd.*, 558 F.2d 1214 (8th Cir. 1978).

In the instant case, the Court entered its Order on April 11, 1996, and Plaintiffs filed their Motion to Vacate Judgment on April 25, 1996. Pursuant to the time computation rules set forth in Fed. R. Civ. P. 6(a), the April 25, 1996 Motion was not timely filed. Therefore, the Court must view Plaintiffs' Motion to Vacate under the standards of Fed. R. Civ. P. 60(b).

2. *Standard for Rule 60(b)*

Fed. R. Civ. P. 60(b) "authorizes an extraordinary remedy that allows a court to 'preserve the delicate balance between the sanctity of final judgments and the incessant command of a court's conscience that justice be done in light of all the facts.'" *Hoover v. Valley West D M*, 823 F.2d 227, 230 (8th Cir. 1987) (citing *Rosebud Sioux Tribe v. A & P Steel, Inc.*, 733 F.2d 509, 515 (8th Cir.), *cert. denied*, 469 U.S. 1072 (1984)). Specifically, Rule 60(b)(1) provides that the court may relieve a party from a final judgment on grounds of "mistake, inadvertence, surprise, or excusable neglect." With the foregoing standards in mind, the Court now turns to a discussion of Plaintiffs' Motion to Vacate.

3. *Analysis*

Plaintiffs' Motion to Vacate requests relief under Fed. R. Civ. P. 60(b) on grounds of mistake, as follows:

> 1. The Memorandum and Order of April 11, 1996 erroneously applied Federal Rule of Civil Procedure 9(b) to Counts I and II of Plaintiffs' Consolidated Amended Class Action Complaint. Counts I and II are pleaded under Sections 11 and 12(2) of the Securities

> Act of 1933 respectively and by statute, scienter or fraud is not an element of such claims and therefore such claims are not required to be pleaded with particularity since rule 9(b) is inapplicable.

(Plaintiffs' Motion to Vacate, P. 2). Fed. R. Civ. P. 9(b) reads in pertinent part: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Plaintiffs therefore allege that because scienter and fraud are not necessary elements of claims under either Section 11 or 12(2), the particularity requirements of Rule 9(b) do not apply.

Plaintiffs are correct in their assertion that a claimant under Sections 11 or 12(2) need not allege scienter. *See, e.g., Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983) ("However, a Section 10(b) plaintiff carries a heavier burden than a Section 11 plaintiff. Most significantly, he must prove that the defendant acted with scienter, i.e., with intent to deceive, manipulate, or defraud"); *Wigand v. Flo-Tek. Inc.*, 609 F.2d 1028, 1034 (2d Cir. 1979) ("Actions under section 12(2) do not require a showing by the plaintiff of any kind of scienter on the part of the defendant").

However, "[t]he mere fact that plaintiffs need not prove scienter to recover under SS 11 and 12(2) does not mean that SS 11 and 12(2) claims can never 'sound in fraud.' On the contrary, a plaintiff may allege, under SS 11 and 12(2), a scheme which, if proven, would constitute fraud." *Hershey v. MNC Financial, Inc.*, 774 F.Supp. 367, 375 (D.Md. 1991). Plaintiffs have alleged just such a scheme in the present case. Counts I and II incorporate by reference the factual allegations contained in Paragraphs 1-65 of the Consolidated Amended Class Action Complaint. Although such statements do not speak specifically of fraud, they nevertheless allege behavior that, if proven, would be fraudulent

in nature.[2] The question for the Court is therefore whether Sections 11 and 12(2) claims that "sound in fraud" are subject to Rule 9(b).

Rule 9(b) refers to "averments" of fraud, and therefore requires the Court to look beyond the superficial wording of the charges and "examine the factual allegations that support a particular legal claim." *Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 288 (3d Cir. 1992); *Hershey v. MNC Financial, Inc.*, 774 F.Supp. at 375 ("Its (Rule 9(b)'s) application should depend on the substance of a plaintiff's allegations, not upon the guise

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[2] Examples of Plaintiffs' allegations of fraudulent conduct include:

> 2. By the time the long-delayed NationsMart Offering closed on December 22, 1993, defendants *knew* that cost and revenue trends had moved consistently and materially in the wrong directions. Rather than cancel the Offering, the defendants *concealed the adverse developments*, which severely compromised the viability of NationsMart's purported business plan...
>
> 30. Defendants *knew* that the representations in the Offering Materials that the Company could fulfill its business plan through October 1994 were false and misleading and not reasonably based. Defendants *knew* that the sales forecasts upon which the statements were based were not justifiable or reasonable based on historical data.
>
> 31. ... The defendants *knew* that the projections they intended to release to the investing public, including the Class, were false and had no reasonable basis because they *knew* that there were no valid assumptions underlying the projections.

(Plaintiffs' Consolidated Amended Class Action Complaint, ¶¶ 2, 30, and 31) (emphasis added). Plaintiffs incorporated the above allegations into their Count I Section 11 claim in Paragraph 66, and into their Count II Section 12(2) claim in Paragraph 75.

in which he portrays them"). In the present case, despite their protestations to the contrary,[3] Plaintiffs' allegations clearly constitute 'averments of fraud.' The Counts speak of knowing and willful behavior on Defendants' parts rather than negligence, and thus "the only reasonable conclusion that can be drawn is that plaintiffs charge defendants with fraud." *Shapiro v. UJB Financial Corp.*, 964 F.2d at 287-88. The Court therefore did not error in applying Rule 9(b)'s particularity requirements to Plaintiffs' allegations, and its earlier ruling will be affirmed. Plaintiffs' Motion to Vacate is hereby denied.

MOTION FOR LEAVE TO AMEND

In their Motion, Plaintiffs alternatively request leave to amend their Complaint to comply with the strictures of Rule 9(b). This request will be denied as well.

A District Court has broad discretion to grant or deny leave to amend, "...particularly where the court has already given a plaintiff one or more opportunities to amend his complaint..." *Mir v. Fosburg*, 646 F.2d 342, 347 (9th Cir. 1980). Leave to amend may further be denied for reasons including "undue delay, bad faith or dilatory motive by the movant, undue prejudice to the opposing party, and futility of amendment." *Perkins v. Spivey*, 911 F.2d 22, 34 (8th Cir. 1990) (citations omitted). In

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[3] Plaintiffs include the following disclaimers in Counts I and II, respectively:

> 74. Plaintiffs do not allege in this Section 11 claim that defendants, or any of them, were guilty of scienter, that is, of any scheme to defraud or of any misrepresentations or omissions that were made intentionally or recklessly.
>
> 80. Plaintiffs do not allege in this Section 12(2) claim that defendants, or any of them, were guilty of scienter, that is, of any scheme to defraud or of any misrepresentations or omissions that were made intentionally or recklessly.

(Plaintiffs' Consolidated Amended Class Action Complaint, ¶¶ 74, 80).

the present case, Plaintiffs utilized several Court-granted opportunities to amend their Complaint. For example, on November 14, 1994 Plaintiffs amended their Complaint to alter the designated Plaintiffs, and on May 1, 1995 Plaintiffs consolidated several earlier complaints into the Consolidated Amended Class Action Complaint. Plaintiffs had further opportunity to amend when they brought in the additional underwriters as Defendants. Undue delay therefore appears to be a factor here, as Plaintiffs possessed ample opportunity to cure the defects in their Complaint before the scheduling deadline of September 30, 1995.

Plaintiffs maintain, however, that they were unable to take advantage of the earlier opportunities to add specificity to their Complaint, because they were unaware that the sufficiency of their pleadings was being attacked. Plaintiffs allege that the need to amend their Complaint only became apparent when the Court granted Defendants' Motion to Dismiss based on failure to plead with particularity. Under such reasoning, Plaintiffs assert that their Motion for Leave to Amend, submitted only fourteen days after entry of the Court's Memorandum and Order, was timely filed and should be granted.

Upon careful review of the pleadings and proceedings, however, the Court finds that, contrary to the allegations in Plaintiffs' Motion for Leave to Amend, Plaintiffs were on notice that the sufficiency of their pleadings were being attacked as early as July 17, 1995. On that date, Defendant Underwriters filed their Motion to Dismiss as to Non-Projection Allegations. The basis for such Motion was explicitly stated as follows:

> The grounds for this Motion are that Plaintiffs' allegations of securities fraud based otherwise than on the projections and forward-looking statements contained in the December 22, 1993 Prospectus *fail to allege the circumstances constituting any fraud on the part of the Underwriters with particularity as required by Rule*

> *9(b) Fed. R. Civ. P.* For that reason, such allegations fail to state any claim upon which relief can be granted against the Underwriters and must be dismissed.

(Underwriters' Motion to Dismiss as to Non-Projection Allegations, P. 1) (emphasis added). The Rule 9(b) allegations are thus abundantly clear, and Defendant Underwriters continued to give numerous examples of facts that Plaintiffs' Complaint failed sufficiently to assert. Several of Defendants' other Motions to Dismiss introduced the Rule 9(b) issue as well,[4] and Plaintiffs actually responded to the allegations in their Memorandum of Law in Opposition to Defendants' Motions to Dismiss.[5] Thus Plaintiffs may not allege that they were unaware the Court would consider the Rule 9(b) particularity issue in ruling on Defendants' Motions to Dismiss.

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[4]Examples of Defendants' 9(b) allegations include the following:

1. "Plaintiffs allege liability in Counts I and III under § 15 of the 1933 Act and §20 of the 1934 Act for 'control persons' without identifying who they claim are such 'control persons.' These allegations should be dismissed for failure to plead fraud with particularity under Rule 9(b)." (Defendants' Memorandum in Support of their Motion to Dismiss all Claims Based on Allegations other than Prospectus Projections, P. 18).

2. "Moreover, vague and conclusory conspiracy allegations are totally insufficient under Rule 9(b), which requires specificity where fraud is alleged." (Reply Memorandum Supporting Underwriters' Motion to Dismiss as to Non-Projections Allegations, P. 2).

[5]For example, Plaintiffs stated as follows:

> The defendants next assert that the plaintiffs have not adequately pleaded the predicates for the fraud on the market doctrine,... Under notice pleading, there is no rule as to how specifically an efficient market must be pleaded... And even if there were such a rule, the operative allegations of the Complaint regarding market efficiency are plainly sufficient. They include: (Plaintiffs continue to cite the particular details of their claim.)

(Plaintiffs' Memorandum of Law in Opposition to Defendants' Motions to Dismiss, P. 31).

It should be noted that in stating the above, the Court does not hold that Plaintiffs were required to submit the Amended Complaint solely because Defendants challenged the sufficiency of their original. Such a burden would clearly be too onerous. However, in order to preserve their right to amend the Complaint, Plaintiffs needed only to request in their Response to Defendants' Motions to Dismiss that, should the Court decide to grant the motions on 9(b) grounds, the scheduling deadlines then be extended to permit Plaintiffs an opportunity to amend their Complaint. Plaintiffs failed to make such a request, however, and instead permitted the scheduling deadline to pass and the case to be dismissed before requesting leave to amend. Plaintiffs have not provided an adequate explanation for their failure to request leave to amend before judgment was entered.[6] *Figgie*

[6] Plaintiffs attempt to explain such failure by alleging that the information contained in their (Proposed) Consolidated Second Amended Class Action Complaint was not provided to them until after the Court's ruling of April 11, 1996. However, Plaintiffs do not dispute Defendants' allegations that thousands of documents were made available for review in the fall of 1995, and that no significant information came to Plaintiffs' attention in the weeks immediately preceding the Order. (Dismissed Defendants' Memorandum in Opposition to Plaintiffs' Motion to Vacate and for Leave to Amend, P. 8, FN 6). Thus, Plaintiffs should have moved for leave to amend when the information forming the basis of the (Proposed) Second Amended Class Action Complaint became available, well before dismissal was ordered on April 11, 1996.

Internat'l, Inc. v. Miller, 966 F.2d 1178, 1181 (7th Cir. 1992). Therefore, the Court holds that Plaintiffs' lack of diligence in raising the issue pre-judgment constituted undue delay, and Plaintiffs' Motion for Leave to Amend is denied.[7] *Id.*

In light of the Court's decision to affirm its earlier Order, Defendant Brueggemann's Motion to Strike Immaterial, Impertinent, and Scandalous Allegations from Plaintiffs' (Proposed) Second Amended Complaint will be denied as moot, Defendant Brueggemann's Motion to Place Previously Filed Motion under Seal will be denied as moot, and Defendant NationsMart's Motion to Vacate a Portion of the Discovery Order of October 15, 1996 will be granted.

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[7] The Court further disagrees with Plaintiffs' assertion that good cause exists to alter the scheduling order to permit the amendment. In the case cited by Plaintiffs, the Court held as follows:

> If the need to amend a pleading arises after the deadline expires and there is no offsetting factor, the deadline would probably be extended. On the other hand, if the reason for seeking the amendment is apparent before the deadline and no offsetting factors appear, the Rule 16 deadline must govern.

Financial Holding Corp. v. Garnac Grain Co., 127 F.R.D. 165, 166 (W.D.Mo. 1989). As stated above, Plaintiffs' reason for seeking the extension, i.e., to grant them time (if necessary) to cure the defects of their pleadings, was apparent months before the Rule 16 deadline, and so Plaintiffs' Motion for Leave to Amend must be denied.

CONCLUSION

Accordingly,

IT IS HEREBY ORDERED that dismissed Defendants' Motion for Leave to Cite Additional Authority in Opposition to Plaintiffs' Motion to Vacate (Docket #00, filed May 31, 1996 is **GRANTED**.

IT IS FURTHER ORDERED that Plaintiffs' Motion Pursuant to Federal Rules of Civil Procedure 59(e) and 60(b) to Vacate the April 11, 1996 Memorandum and Order of the Court (Docket #100) is **DENIED**.

IT IS FURTHER ORDERED that Plaintiffs' Motion Pursuant to Rules l 5(a) and 16(b) for Leave to Amend (Docket #100) is **DENIED**.

IT IS FURTHER ORDERED that Defendant Brueggemann's Motion to Strike Immaterial, Impertinent, and Scandalous Allegations from Plaintiffs' (Proposed) Second Amended Complaint (Docket #107) is **DENIED** as moot.

IT IS FURTHER ORDERED that Defendant Brueggemann's Motion to Place Previously Filed Motion under Seal (Docket #0, filed June 5, 1996) is **DENIED** as moot.

IT IS FURTHER ORDERED that Defendant NationsMart's Motion to Vacate a Portion of the Discovery Order of October 15, 1996 (Docket #128) is **GRANTED**.

Dated this 6th day of November, 1996.

/s/ Jean C. Hamilton
UNITED STATES DISTRICT JUDGE

APPENDIX D

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

Case No. 4:94CV2182 JCH

In re NationsMart Corporation
Securities Litigation

This Document Relates To:
All Actions

MEMORANDUM AND ORDER

This matter is before the Court on Defendant's Motion to Amend Order of November 6, 1996. The Court's November 6, 1996 Order dismissed Plaintiff's Motion to Alter or Amend Judgment pursuant to Fed. R. Civ. P. 59(e) as untimely filed. In their motion, however, Defendants correctly note that the Court miscalculated the date on which Plaintiff's motion was due. Defendants therefore request that Plaintiff's motion, timely filed April 25, 1996, be considered and denied on its merits.

Upon careful review of both the record and its November 6, 1996 Order, the Court finds that Plaintiffs were not prejudiced by the dismissal of their 59(e) motion. Although the Court dismissed the Rule 59(e) motion for lack of jurisdiction, the Court fully considered Plaintiff's Rule 60(b) motion to vacate the April 11, 1996 Order. Rule 59(e) provides only limited grounds for altering or amending a judgment. In contrast, Plaintiff's alternative motion to vacate permitted the Court greater discretion in determining whether to vacate or amend the earlier Order. Further, in analyzing Plaintiff's motion to vacate, the Court took into account the arguments Plaintiffs raised with respect to their Rule 59(e) motion. Therefore, although the Court did not con-

sider the grounds Plaintiffs raised under the guise of a Rule 59(e) motion, the Court considered those grounds nonetheless. The Court thus finds it unnecessary to vacate its earlier Order dismissing Plaintiff's Rule 59(e) motion, despite the timely filing.

In accordance with the foregoing,

IT IS HEREBY ORDERED that Defendants' Motion to Amend Order of November 6, 1996 [docket #134] is **GRANTED**.[1]

Dated this 2nd day of December, 1996.

/s/ Jean C. Hamilton
UNITED STATES DISTRICT JUDGE

[1] The Court's Order of November 6, 1996 is hereby amended to deny Plaintiff's 59(e) Motion to Alter or Amend Judgment on the merits, rather than on jurisdictional grounds.

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 96-4132EMSL

In re: NationsMart Corporation
Securities Litigation

Michael E. Thaman, et al.,
Appellees,
v.
Jack Carlon, et al.,
Appellants.

Order Denying Petition for Rehearing and
Suggestion for Rehearing En Banc

The suggestion for rehearing en banc is denied. Judge Beam would grant the suggestion.

The petition for rehearing by the panel filed by Ras Securities Corporation and Pauli & Company, Inc. is also denied. Judge Beam would grant the petition. The appellants and appellees shall bear their own costs.

January 15, 1998

Order Entered at the Direction of the Court:
/s/ Michael E. Gans
Clerk, U.S. Court of Appeals, Eighth Circuit

APPENDIX F

RELEVANT STATUTES AND REGULATIONS

Section 11 of the Securities Act of 1933

Securities Act of 1933, May 27, 1933, Ch. 38, Tit. I, § 11, 48 Stat. 74, 82 (1933), *as amended by* Act of June 6, 1934, Ch. 404, Tit. II, § 206, 48 Stat. 907. (codified as amended at 15 U.S.C. § 77k (1994)).[1]

§ 77k. Civil liabilities on account of false registration statement

(a) Persons possessing cause of action; persons liable. In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

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[1] Following commencement of this case, this statutory provision was amended by the Private Securities Litigation Reform Act of 1995, P.L. 104-67, Tit. I, § 105, 109 Stat. 757 (1995) (current version at 15 U.S.C. § 77k (Supp. I 1995).

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement, in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

(b) Persons exempt from liability upon proof of issues. Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof —

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1), and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the

registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

(c) Standard of reasonableness. In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

(d) Effective date of registration statement with regard to underwriters. If any person becomes an underwriter with respect to the security after the part of the registration statement with respect to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.

(e) Measure of damages; undertaking for payment of costs. The suit authorized under subsection (a) may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Provided, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public. In any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if

the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

(f) Joint and several liability. All or any one or more of the persons specified in subsection (a) shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

(g) Offering price to public as maximum amount recoverable. In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.

Section 12(2) of the Securities Act of 1933

Securities Act of 1933, May 27, 1933, Ch. 38, Tit. I, § 12(2), 48 Stat. 74, 84 (1933), *as amended by* Act of Aug. 10, 1954, Ch. 667, Tit. I, § 9, 68 Stat. 686 (codified as amended at 15 U.S.C. § 77*l*(2) (1994)).[2]

§ 77*l*. Civil liabilities arising in connection with prospectuses and communications

Any person who —

. . .

> (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security

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[2] Following commencement of this case, this statutory provision was moved and renumbered as Section 12(a)(2) by the Private Securities Litigation Reform Act of 1995, P.L. 104-67, Tit. I, § 105, 109 Stat. 757 (1995) (current version at 15 U.S.C. § 77*l*(a)(2) (Supp. I 1995)). In order to maintain consistent references throughout the decisions in this case, all references to this provision herein are to Section 12(2) of the 1933 Act, as opposed to Section 12(a)(2).

with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Securities and Exchange Commission Rule 175

17 C.F.R. part 230.175

Rule 175. Liability for Certain Statements by Issuers

(a) A statement within the coverage of paragraph (b) of this rule which is made by or on behalf of an issuer or by an outside reviewer retained by the issuer shall be deemed not to be a fraudulent statement (as defined in paragraph (d) of this rule), unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.

(b) This rule applies to the following statements:

(1) A forward-looking statement (as defined in paragraph (c) of this rule) made in a document filed with the Commission, in Part I of a quarterly report on Form 10-Q and Form 10-QSB, or in an annual report to shareholders meeting the requirements of Rules 14a-3(b) and (c) or 14c-3(a) and (b) under the Securities Exchange Act of 1934, a statement reaffirming such forward-looking statement subsequent to the date the document was filed or the annual report was made publicly available, or a forward-looking statement made prior to the date the document was filed or the date the annual report was publicly available if such statement is reaffirmed in a filed document, in Part I of a quarterly report on Form 10-Q and Form 10-QSB, or in an annual report made publicly available within a reasonable time after the making of such forward-looking statement;

Provided, That

(i) At the time such statements are made or reaffirmed, either the issuer is subject to the reporting requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and has complied with the requirements of Rule 13a-1 or 15d-1 thereunder, if applicable, to file its most recent annual report on Form 10-K and Form KSB, Form 20-F, or 40-F; or if the issuer is not subject to the reporting requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, the statements are made in a registration statement filed under the Securities Act of 1933, offering statement or solicitation of interest written document or broadcast script under Regulation A or pursuant to section 12(b) or (g) of the Securities Exchange Act of 1934, and

(ii) The statements are not made by or on behalf of an issuer that is an investment company registered under the Investment Company Act of 1940; and

(2) Information which is disclosed in a document filed with the Commission, in Part I of a quarterly report on Form 10-Q and Form 10-QSB or in an annual report to shareholders meeting the requirements of Rules 14a-3(b) and (c) or 14c-3(a) and (b) under the Securities Exchange Act of 1934 and which relates to (i) the effects of changing prices on the business enterprise, presented voluntarily or pursuant to Item 303 of Regulation S-K or Regulation S-B or Item 9 of Form 20-F, "Management's discussion and analysis of financial condition and results of operations," or Item 302 of Regulation S-K, "Supplementary financial information," or Rule 3-20(c) of Regulation S-X, or (ii) the value of proved oil and gas reserves (such as a standardized measure of discounted future net cash flows relating to proved oil and gas reserves as set forth in paragraphs 30-34 of State-

ment of Financial Accounting Standards No. 69) presented voluntarily or pursuant to Item 302 of Regulation S-K.

(c) For the purpose of this rule the term "forward-looking statement" shall mean and shall be limited to:

(1) A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;

(2) A statement of management's plans and objectives for future operations;

(3) A statement of future economic performance contained in management's discussion and analysis of financial condition and results of operations included pursuant to Item 303 of Regulation S-K or Item 9 of Form 20-F; or

(4) Disclosed statements of the assumptions underlying or relating to any of the statements described in paragraphs (c)(1), (2) or (3) above.

(d) For the purpose of this rule the term "fraudulent statement" shall mean a statement which is an untrue statement of a material fact, a statement false or misleading with respect to any material fact, an omission to state a material fact necessary to make a statement not misleading, or which constitutes the employment of a manipulative, deceptive, or fraudulent device, contrivance, scheme, transaction, act, practice, course of business, or an artifice to defraud, as those terms are used in the Securities Act of 1933 or the rules or regulations promulgated thereunder.